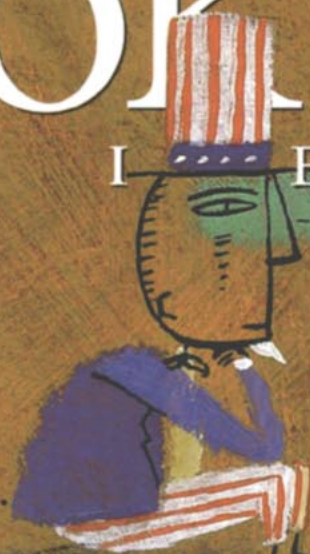


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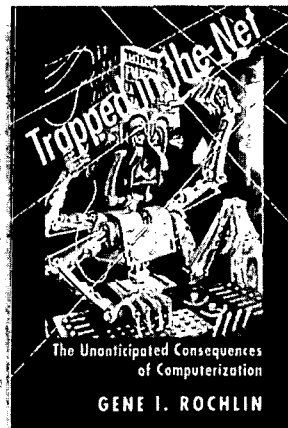
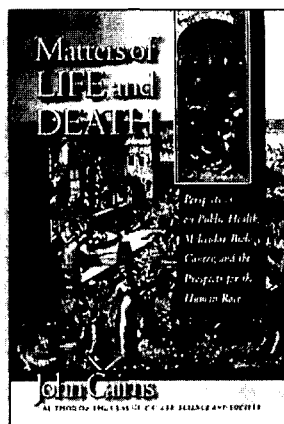
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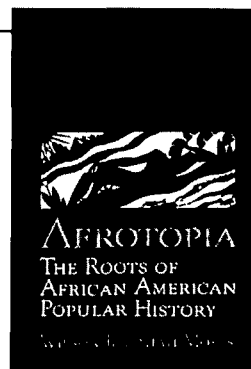
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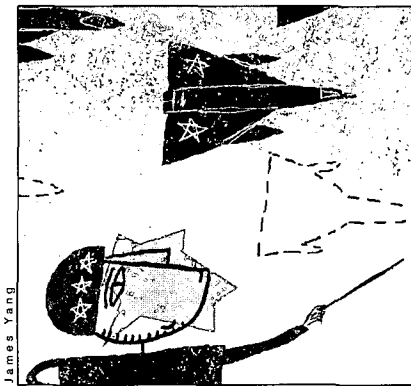
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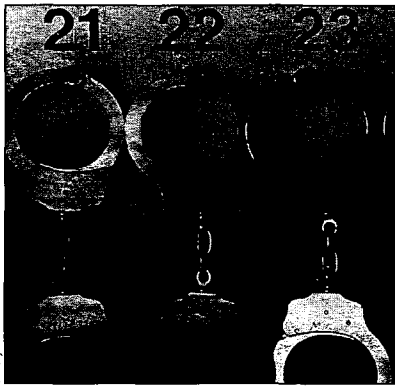
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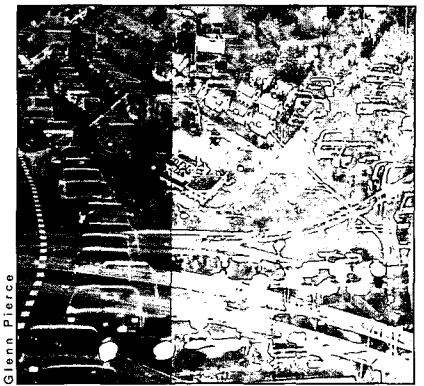
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Thomas E. Mann

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Citizens to the Rescue

Surely 1998 will not go down in the annals of American history as a year ennobling for the president, productive for the Congress, or triumphant for the press. To the extent that the health of our democracy depends on the good judgement, restraint, and public regard- ingness of political elites, the year was down- right depressing. Fortunately, the other key actor in the polity—the citizenry—stepped into the void when no responsible adults were to be found in Washington. Expressing themselves initially through the much- maligned polls and eventually in the November elections, they (as someone clever noted) turned James Madison on his head. Rather than the mob whose passions had to be cooled by their more deliberate leaders, the public refined and enlarged the views of the Washington community and, in so doing, provided some much-needed perspective and incentives for politicians to refocus their attention on matters of genuine importance to the country.

Until news first broke in January of the president's sexual relationship with a former White House intern and of the investigation by Independent Counsel Kenneth Starr of possible perjury and obstruction of justice in the civil suit brought against the president by Paula Jones, the year had already shown signs of promise, in spite of the lame-duck status of the president. With federal budget deficits rapidly turning into surpluses, the president seemed well positioned to rally his party behind government initiatives on tobacco, education, and health and to begin a national conversation on how best to ensure the long-term financial stability of Social Security. Clinton's reckless behavior with Monica Lewinsky, his dissembling under oath, and the seven-month lapse between his initial public lie and his ultimate acknowledgment demeaned the presidency, eroded critical privileges of the office, betrayed his staff and allies, squandered his opportunity to shape the congressional agenda, and embarrassed the nation. There is no avoiding the conclu-

sion that Clinton himself is largely to blame for this whole tawdry business.

But unfortunately he had a big supporting cast. The Supreme Court contributed with its inexplicable unanimous ruling that the Jones civil suit could go forward while Clinton served as president. Seldom have the Court's words—"It appears to us highly unlikely to occupy any substantial amount of the presi- dent's time"—looked so foolish so quickly. The president's personal attorney can be faulted (whether through misjudgment or insufficient persuasiveness with his client) for failing to settle with Jones, or to plead no contest, and thereby avoid an invasive discov- ery and deposition. By virtue of its active pursuit of expanded jurisdiction and its aggressive, strong-armed tactics better suited to investigating organized crime than possible lying by the president of the United States in a civil sexual harassment lawsuit, the Office of Independent Counsel Starr managed to raise more questions in the public's mind about the political roots of the prosecution than it answered about the president's misbe- havior. The *coup de grace* was Starr's referral to the House, which through its aggressive advocacy for impeachment and numbing detail on the president's sexual encounters destroyed any hope that the investigation would garner the credibility intended by the Independent Counsel statute.

Then there is the behavior of the press. One hardly knows where to begin. From the breathless forecasts by celebrity journalists of the president's imminent departure from office, to months of weakly sourced "break- ing news" stories by Woodward and Bernstein wannabes whose idea of investiga- tive reporting is to be an unfiltered conveyor belt for strategic leaks by the Office of Independent Counsel and White House, to the 24-hour "All Monica, All the Time" cable news entertainment shows featuring partisan food fights among pseudo experts, to the scores of editorials and columns dripping with contempt for the president and the



Thomas E. Mann is W. Averell Harriman Senior Fellow in American Governance and director of the Brookings Governmental Studies program.

public, media coverage of this presidential scandal and its appropriate place in national politics and policymaking has been a wasteland.

Politicians in Congress only made matters worse. The majority Republicans, content to rest on their laurels and allow the president's scandal to play out over the course of the year, advanced no serious legislative program. Their decision to release Starr's referral immediately, without first reviewing its contents or giving the president an opportunity to respond, raised questions about basic fairness. Subsequent data dumps (including videotapes of the president's grand jury testimony), all rationalized by "the public's right to know," seemed more like an abdication of congressional responsibility, especially in light of later protestations that "we must fulfill our constitutional responsibilities whatever the views of the public." The hurried decision to open a formal impeachment inquiry, made in the politically charged period just before a national election without any real deliberation on the charges, the evidence, and what constitutes an impeachable offense, certainly reinforced that impression.

Congressional Democrats were hardly the model of dispassionate judgment and stability. After initial disbelief and then disingenuous acceptance of the president's public denial, they reacted angrily to his August 17 speech acknowledging a sexual relationship with Lewinsky. Many spoke emotionally about their feelings of betrayal and shame and contributed to the escalating pressure on the president to resign. Later, when it became clear that the public's resolute opposition to impeachment or resignation was unlikely to diminish, Democrats charted an entirely different course, one seemingly designed primarily to impeach the president's chief accuser.

What is most striking about this entire affair was the certainty among Washington elites that measures of strong public approval of the president's performance, which were remarkably stable throughout the year, could not be taken seriously—either because of the inadequacy of the polls or the likelihood that public opinion would change as details of Starr's investigation became more widely known. But it is now clear that this enlightened Washington perspective was flat out wrong. The public has had no difficulty applauding Clinton's performance as president while disapproving of his marital infidelity and untruthfulness. Their regard for him as a person has diminished during the course of the year while their appreciation of how well the country and their families have done under his stewardship has intensified. They have been at least as wary of the dangers to a free society from the abuse of public authority by prosecutors as by presidents. They sense an inappropriate politicization of the legal process—in which investigations become weapons used in combat between competing partisans. At the same time they do not take lightly the president's irresponsible behavior. The point is to find a punishment that fits the misbehavior and limits the collateral damage to the country. In the public's view, that means censure or reprimand (and potential criminal liability after he leaves office), not impeachment or resignation. And importantly it means turning the attention of the policymaking community away from this scandal and back to those matters that affect the lives of American citizens.

Through public opinion polls and the midterm elections, citizens have sent a crystal-clear message to Washington: it's time to bring down the curtain on the national soap opera and get about the task of setting national priorities. ■

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*Design and art direction by
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Printed in U.S.A.

*Subscriptions: one year \$17.95
(\$24.95 foreign); two years \$32.95
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Postmaster, send address changes to:

*Brookings Review,
1775 Massachusetts Ave., N.W.,
Washington, D.C. 20036*

*Second-class postage paid
at Washington, D.C.
USPS I.D. No. 010-099;
Publication No. 551640.*

Reprint permissions: (202) 797-2483

*U.S. newsstand distribution by:
Ingram Periodicals Inc.
1117 Heil Quaker Blvd.
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*Brookings Review
(ISSN 0745-1253) is published
quarterly by the
Brookings Institution Press.*

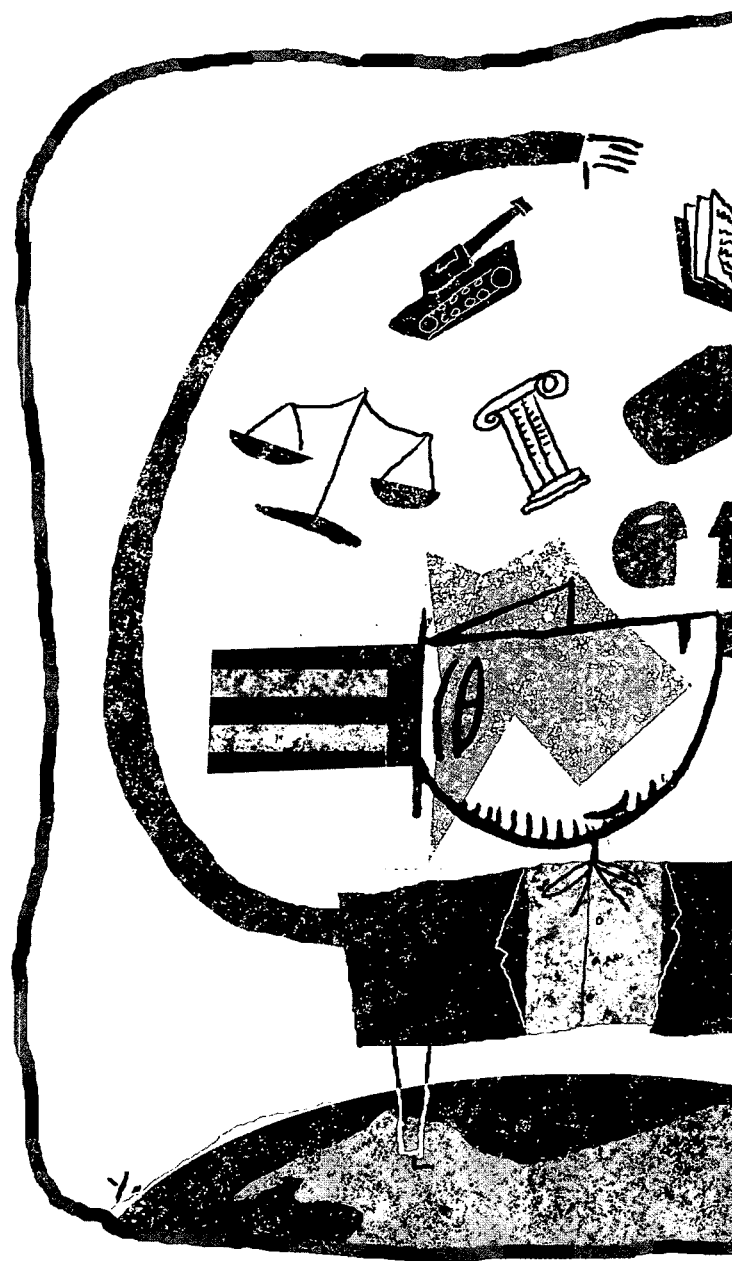
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SETTING NATIONAL PRIORITIES

The New Environment

BY ROBERT D. REISCHAUER

THE ENVIRONMENT in which the debate over national priorities takes place has changed markedly over the past decade. The Cold War has ended, fortunately with a whimper not a bang, allowing the United States to scale back its military forces substantially and begin to redefine its relations with other nations. The pall that large and seemingly intractable budget deficits have cast on public sector initiatives as well as efforts to reduce tax burdens has lifted. After 28 years of uninterrupted red ink, the federal budget registered a surplus in fiscal 1998, and projections suggest that surpluses will continue for more than a decade if current tax and spending policies are not changed dramatically. While economic weakness abroad has created great uncertainty, the nation's economy remains unusually strong and resilient. The fraction of the adult population employed is at a record level, wages are growing across the income spectrum, and inflationary pressures continue to be remarkably subdued.



Furthermore, some of the most stubborn and divisive domestic problems of the 1970s and 1980s have moderated over the course of the 1990s. Crime rates have declined for several years. The number of people receiving welfare benefits has fallen more than 40 percent from its peak in 1994. Teen pregnancy and birth rates have fallen a little since the early 1990s. And the fiscal pressures that long crippled states and localities have eased, allowing them to address their problems without first begging for federal grants.

To be sure, the nation's problems have not disappeared. Growing numbers of people lack adequate health insurance; the elementary and secondary educational system continues to produce too many poorly educated graduates for a nation

and executive branches over just what the nation's priorities should be becomes difficult. With a presidential election less than two years away, cooperation across party lines becomes increasingly rare.

In spite of these obstacles, a consensus is emerging that issues involving elementary and secondary education, the family, and the consequences of rapid change in the health delivery system should be among the nation's top priorities. There is also growing agreement that, after a decade of retrenchment, it is time to reexamine the level of resources devoted to defense. Issues such as world trade, crime, and taxes remain on the agendas of many involved in the policy process.

While much attention remains focused on issues of immediate concern, the new policy environment has made it possible for policymakers to think about addressing the larger challenges that await the nation in the second and third decades of the next century. These involve the viability of the nation's basic retirement programs—Social Security and Medicare. After a year-long educational effort involving town meetings, debates, and discussion, the president and congressional leaders will try, early in 1999, to hammer out a plan to deal with Social Security's long-term fiscal imbalance. In March of 1999, the National Bipartisan Commission on the Future of Medicare, which was created by the Balanced Budget Act of 1997, will

In theory, the new, more benign policy environment should permit lawmakers to rank and address public policy priorities in a more deliberative and reasoned manner than was possible in the past.

that will lead the world into the 21st century; income disparities continue to widen; and many children are raised in families with inadequate resources.

In theory, the new, more benign policy environment should permit lawmakers to rank and address these and other priorities in a more deliberative and reasoned manner than was possible in the past. Whether they will avail themselves of this opportunity remains to be seen. With narrow congressional majorities, partisan divisions run deep on Capitol Hill. With Republicans split into moderate and conservative camps and Democrats divided among liberal, moderate, and conservative factions, leaders have a difficult time defining a party position on many issues let alone finding common ground with those across the aisle. With the White House and Congress controlled by different parties, agreement between the legislative

issue its recommendations for strengthening the health insurance program that is so vital to the aged and disabled. Both problems are complex, and their solutions inevitably will be divisive. If even one of them could be resolved within the next year or two, it would represent a major triumph for the nation's policymaking process, one that would build public confidence in government. If these efforts end in acrimonious debate and a deluge of demagoguery, the divisiveness could spill over into other policy areas, poisoning any effort to cooperate across party and ideological lines on policy development.

The following seven articles, most drawn from longer pieces in the forthcoming Brookings volume *Setting National Priorities*, analyze some of the important issues that are on the agendas of policymakers in the final year of the 20th century. ■

Robert D. Reischauer is a senior fellow in the Brookings Economic Studies program and editor, with Henry J. Aaron, of Setting National Priorities (Brookings, forthcoming).

James Yang

SHOULD WE RETIRE SOCIAL SECURITY?

Grading the Reform Plans

BY HENRY J. AARON AND ROBERT D. REISCHAUER

Most Americans understand that Social Security faces a long-term imbalance between the cost of benefits promised under current law and the program's projected income. They realize that the looming deficits arise from the coming retirement of the large baby boom cohort, the steady increase in life expectancies, and the reduction in fertility rates, not from program mismanagement.

Nevertheless, many wonder whether Social Security, devised during the Great Depression, amidst double-digit unemployment, pervasive poverty, and the inability of all but a few to save for retirement, is suitable for today's vastly changed economic, social, and financial conditions.

Today, policymakers and the public face a bewildering array of proposals to reform or replace the nation's public pension system. Fortunately for the interested citizen, most proposals take one of three approaches to reform. Some replace the current public system with private accounts. Others supplement the current system with private accounts. Still others strengthen and modernize the current system. In what follows we evaluate several prominent plans from each of the three major reform approaches, as well as sketch out one of our own. All the plans would restore financial balance to the nation's basic retirement system.

Criteria for Reform

We evaluate each plan on four criteria: benefit adequacy, protection against risk, administrative efficiency, and effect on national saving.

In our view a successful plan should, first, ensure adequate benefits that are equitably distributed to maintain protection for low earners and other vulnerable people. Current Social Security benefits are not unduly generous.

Henry J. Aaron and Robert D. Reischauer are senior fellows in the Brookings Economic Studies program and the authors of Countdown to Reform: The Great Social Security Debate (A Century Foundation Book, 1998), from which this article is drawn.

Benefits of average earners who retire in the United States at age 65 are less than 1.5 times the U.S. poverty threshold. U.S. benefits replace significantly less of pre-retirement earnings than do public pension benefits in Europe. Large benefit cuts would leave retirees, the disabled, and survivors inadequately protected. At the same time, overall benefit increases are also undesirable because they would push costs, which will grow as baby boomers retire, to very high levels.

Second, the plan should spread broadly the unavoidable risks of long-term pension commitments, not place them on the shoulders of individual workers. Third, administrative costs should be low, and the plan should not be unduly complex for

SOCIAL SECURITY	
REPORT CARD	
Criteria	Grade
Adequacy, equity, and a fair return	C+
Protection against risk	C
Administrative efficiency	F
Increased national saving	B-
Overall grade	C
THE PERSONAL SECURITY ACCOUNTS PLAN	

private businesses, workers, and the government. Finally, the plan should raise national saving by adding to reserves held in the Trust Fund or individual accounts (less any reductions in private saving or government surpluses outside of the retirement system).

Retiring Social Security

Two prominent plans would replace the current Social Security system with individual retirement accounts.

The Personal Security Accounts Plan

The Personal Security Accounts (PSA) plan, advanced by five members of the 1994–96 Advisory Council on Social Security, would gradually replace Social Security with a two-tier system—a flat benefit based on years worked and the age at which benefits are first received and a benefit based on balances accumulated in mandated personal savings accounts. The flat benefit for workers and their spouses, as well as disability and survivor benefits that would be retained but scaled back, would be financed by a payroll tax of 6.2 percent for employers and 1.2 percent for employees; 5 percent of each worker's earnings, up to the maximum subject to the payroll tax, would go into his or her personal account. (The Social Security payroll tax is 12.4 percent of taxable wages—6.2 percent on the employer, 6.2 percent on the worker.)

The PSA plan would be phased in over many years. Retirees and workers over age 55 would remain under the Social Security system. Workers between 25 and 55 would receive a blend of benefits under the new and old systems. Workers under age 25 would receive benefits only under the new system. The new system would run a deficit for the first few decades, forcing the government to borrow some \$2 trillion (in 1998 dollars). Payroll tax rates would jump 1.52 percentage points—0.76 points for the employer, 0.76 points for the worker—for about seven decades to pay the interest costs and repay the principal on that borrowing. Eventually, as Social Security phases out, revenues would exceed costs and the debt would be paid off. When all borrowing had been repaid, the supplemental payroll tax could be repealed.

The PSA flat benefit would guarantee inflation-protected payments (of roughly 75 percent of the current Social Security benefit to low-wage workers) until the worker and his or her spouse died. The personal account benefit would not provide financial protection against inflation (or a long life) unless the worker chose to buy an inflation-indexed annuity with his or her personal account balance. All of the flat benefit, but none of the personal account benefit, would be subject to income tax, a change that would raise taxes on low- and moderate-income retirees and lower taxes on retirees with higher incomes.

Benefit adequacy and equity. The PSA plan promises good benefits for retirees on average but fails to protect certain vulnerable groups. For example, it cuts disability benefits (now provided by Social Security) as much as 30 percent. Because workers would be able to invest their personal accounts in a wide range of assets, some would do well, but others would do poorly and suffer reduced benefits.

Protection against risk. The inflation-adjusted flat benefit would provide excellent protection against risk. Personal account returns would be risky, however, since they would depend on how funds were invested, what administrative fees were imposed by fund managers, how high asset values were when balances were withdrawn, and whether pensioners bought annuities when they retired.

Administrative efficiency. The PSA plan does poorly on this criterion. The Social Security administrative structure would have to be maintained for many years, and two new systems would have to be set up: one to administer the flat benefit and another to see that employers made timely and accurate deposits into personal accounts and that the financial institutions managing personal accounts complied with the unavoidable regulations. The administrative burdens on small employers might be so onerous as to make the plan unworkable. Finally, dramatically higher administrative costs would lower net returns to workers, compared with plans that managed similar investments centrally.

National saving. The PSA plan adds to national saving by raising payroll taxes. But the personal accounts would be so similar to existing IRAs and 401(k) plans that workers might reduce other private saving or increase borrowing. Congress would also come under pressure to give workers access to their accounts—for medical emergencies, say, or college tuition—before retirement. Yielding to such pressure would diminish both the resources for retirement and any positive effect on national saving.

The Feldstein Plan

The second proposal to replace Social Security was crafted by Martin Feldstein, a Harvard economist and former chairman of the Council of Economic Advisers. Under his plan each worker would deposit 2 percent of earnings, up to the maximum subject to the payroll tax, in a personal retirement account. To offset the cost of these deposits, workers would receive an income tax credit financed by the projected federal budget surpluses. Once the surpluses ended, increased federal borrowing, tax increases, or spending cuts would be required.

The personal retirement accounts would be invested in regulated stock and bond funds chosen by the worker and administered by private fund managers. When workers began to draw pensions from their accounts, their Social Security benefits would be reduced by \$3 for every \$4 withdrawn. In effect, the benefits promised by the current Social Security program would become a floor under pensions. Overall, retirees would receive about 60 percent of their benefits from Social Security and 40 percent from personal accounts. Higher earners would depend more on their personal accounts; some would receive nothing from Social Security. The cuts in Social Security benefits would eventually close the projected long-term Social Security deficit.

Benefit adequacy and equity. By tapping into the projected federal budget surpluses, the Feldstein plan would be able to raise pensions—a feature we regard as imprudent in light of the sizable cost of pensions for retiring baby boomers. It would raise benefits more for high earners than low earners. A typical low

earner, with average monthly earnings of \$1,000, would, at retirement, receive a Social Security pension of \$560 and an individual account pension of \$240. When Social Security benefits are reduced by three-quarters of the individual account pension, the low earner's total pension would be \$620, an increase of 11 percent over the current Social Security benefit. A high earner, with average monthly earnings of \$5,600, would receive a Social Security pension of \$1,375 and an individual account pension of \$1,340. The total pension, once Social Security benefits are reduced by three-quarters of the individual account pension, would be \$1,720, an increase of 25 percent. Because high earners are likely to select higher-yielding, albeit riskier, portfolios, their benefits are likely to increase even more.

be affected at all, as the deposits in individual accounts would be funded by budget surpluses. The longer-run effect on saving depends on how successive Congresses and presidents react when the surpluses can no longer sustain the required individual account deposits, as well as on the extent to which workers cut back on other saving.

Reform Social Security and Add Personal Accounts

Another group of proposals would supplement a reduced Social Security system with small defined-contribution personal retirement accounts.

The Individual Account Plan

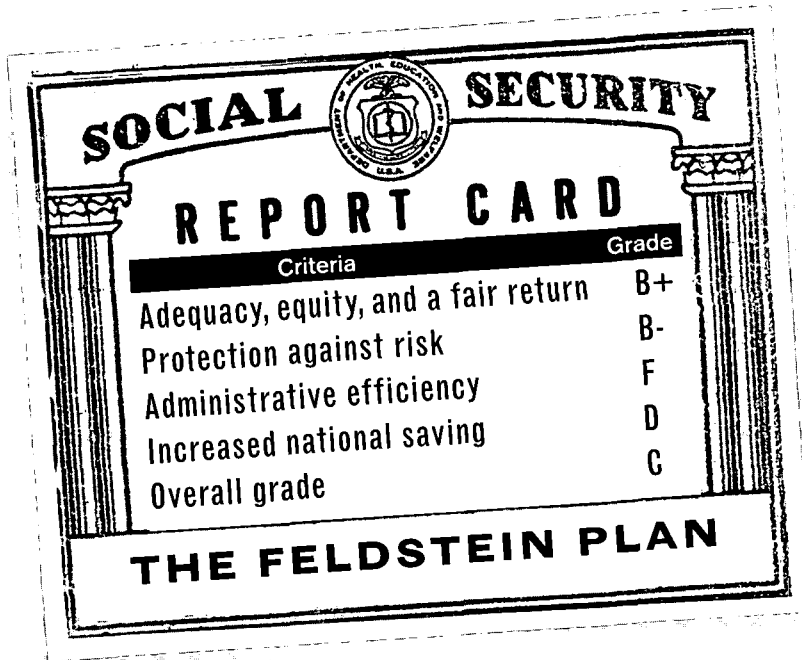
The Individual Account plan, proposed by Edward Gramlich, chairman of the 1994-96 Advisory Council on Social Security, would gradually cut Social Security benefits to allow the current 12.4 percent payroll tax to cover future program costs. Cuts would be small for low earners but up to more than 25 percent for high earners. A 1.6 percentage point increase in the employee payroll tax would finance small personal retirement accounts to be invested in a limited number of index mutual funds managed by a government agency. Balances would be converted into inflation-protected annuities at retirement.

The annuities would be small. A worker with median covered earnings who was 40 years old when the plan was implemented would receive, at age 65, monthly benefits of \$125 (in 1998 dollars), about 13 percent of expected Social Security benefit under the current system. Older workers would start contributing at a later age, contribute for fewer years, and receive less; younger workers would participate longer and receive larger pensions. Because payroll taxes would fully finance the new individual accounts, the plan would require no other transitional taxes or borrowing.

Benefit adequacy and equity. The Individual Account plan would continue to rely heavily on Social Security, although benefits would be cut significantly. On average, pensions financed by individual accounts would fill in this gap for people of retirement age. But disabled workers would suffer reduced benefits until they reached retirement age, and workers who became disabled when young would have little in their individual account even then.

Protection against risk. The individual accounts would be subject to market risk, but the risk would be moderate because investments would be limited to a few centrally managed index funds. The pensions based on individual accounts would form a small portion of future retirees' pensions—about 30 percent for an average earner and 20 percent for a low earner. Both the scaled-back Social Security pension and the individual account pension would be inflation-protected annuities.

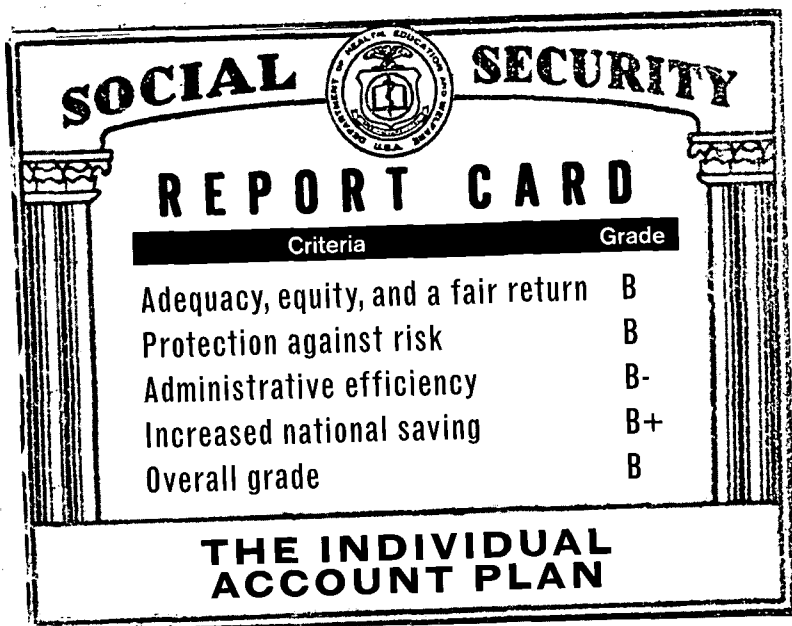
Administrative efficiency. Central administration and the limited number of indexed investments would hold down administrative costs. Nevertheless, these costs would be somewhat higher than those under Social Security because the fed-



Protection against risk. The Feldstein plan provides substantial protection against market risk because it guarantees a pension at least as large as that promised by the current benefit formula. But the plan is likely to undermine political support for a defined-benefit guarantee like Social Security among high and moderate earners, most of whose pensions would be based on their personal accounts. The plan also poses major fiscal risks because the commitment to increased pensions would generate severe budget pressures, particularly after currently projected surpluses end, that would affect all government spending and taxes.

Administrative efficiency. The Feldstein plan would be complex and costly to administer. Administrative and investment management fees will eat into returns on personal account balances. And the Social Security Administration would have to design and operate a system to make the three-quarter reductions in Social Security benefits based on withdrawals from personal accounts.

National saving. The effects of the Feldstein plan on national saving are complicated and unclear. Initially saving would not



eral government would have to deposit funds in accounts of each worker's choice, educate workers about the options, and respond to questions.

National saving. The increased payroll tax and the benefit cuts would both raise national saving. The centrally held individual accounts would probably add to saving because they would not be viewed as good substitutes for IRAs or 401(k) plans.

The Moynihan Plan

Senator Daniel Patrick Moynihan (D-NY) proposes to cut both payroll taxes and Social Security benefits and to authorize—but not require—workers to set up individual accounts. Retirement, survivors, and disability benefits would fall an average of about 20 percent. Payroll taxes would be cut 2 percentage points—1 point for workers and 1 point for employers—until 2025. Workers could spend their share or save it, either in personal accounts administered by a new government board or in special Individual Retirement Accounts managed by financial institutions of their choosing. Contributions of workers who chose to set up personal accounts would have to be matched by their employers. Withdrawal from the account at retirement would be unrestricted; it need not be in the form of an annuity.

From 2025 to 2060 the payroll tax rate would rise gradually to keep program revenues in line with benefit payments. In 2060 the payroll tax rate (by then 13.4 percent), together with contributions to personal accounts, would claim 15.4 percent of covered earnings, 3 percentage points above the current payroll rate. Over time the Moynihan plan would return Social Security to a pay-as-you-go system, with a contingency reserve sufficient to tide the system over a severe economic downturn.

Benefit adequacy and equity. This plan would

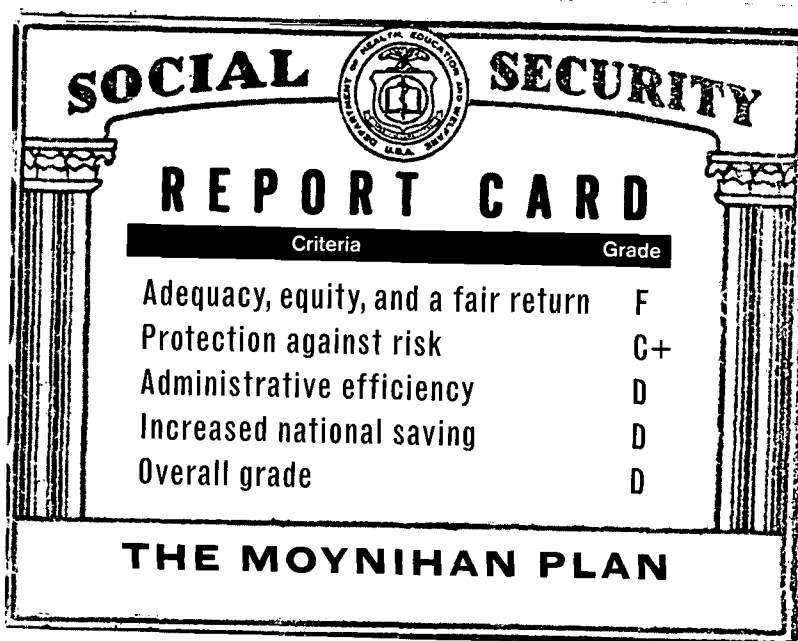
steeply erode benefits and in ways that could hurt vulnerable groups the most. Because benefits would be reduced by holding the annual inflation adjustments 1 percentage point below the Consumer Price Index, those who received benefits the longest—the very old and the long-term disabled—would suffer the largest cuts.

Protection against risk. Because workers could choose how to invest their voluntary accounts, they would be exposed to investment risk. Social Security would provide only partial protection against inflation; pensions derived from the voluntary accounts would offer none. With no restrictions on when or how to convert their account balances into retirement income, some retirees could outlive the pensions based on their personal accounts.

Administrative efficiency. Government administrative costs would rise. The Social Security Administration would be retained in full, and the

government would have to manage a new individual account system and to ensure compliance for private plans. Businesses would have to keep track, pay period by pay period, of whether workers wanted to contribute to individual accounts; whether, for those who did, to deposit funds in the government system or in the private accounts; and, for those who chose the latter, which of many thousands of private fund managers the worker had selected.

National saving. Theoretically, because the plan would deny full inflation adjustments not only for Social Security benefits but also for the personal income tax and all indexed benefit programs except Supplemental Security Income, it would increase national saving. But in practice, Congress is not likely to permit income tax collections to rise over the years (the inevitable con-



sequence of not indexing the tax brackets, exemptions, and the standard deduction) or the purchasing power of entitlement benefits to fall. Thus the plan would lower national saving.

The Breaux-Gregg Plan

The plan proposed by Senators John Breaux (D-LA) and Judd Gregg (R-NH) and others would divert 2 percentage points of the current payroll tax to individual accounts. To cover that cost and to close the projected long-term deficit, the plan would cut Social Security benefits an average of 25–30 percent. At retirement, a worker would be required to convert enough of his or her account balance into an inflation-proof

income while the poverty threshold will increase only at the pace of inflation. If many low and moderate earners received pensions based on the guaranteed minimum rather than on the Social Security benefit formula, the fundamental relationship between contributions (based on earnings) and benefits would be weakened, and political support for the system could diminish. The mandatory annuitization of a portion of the individual accounts would provide protection against outliving one's pension.

Administrative efficiency. The central administration and investment management of the personal accounts would keep costs down. Complexity would arise with the need to calculate the portion of each personal account to be annuitized and to administer both the annuity and the remaining balance.

National saving. Because it does not raise payroll taxes, the plan would not add much in the near term to national saving. Individual accounts would tend to add to national saving because they would not be considered good substitutes for IRAs or 401(k) plans.

Retain and Reform Social Security

The final approach to reform preserves the current defined-benefit system, tying pensions exclusively to each worker's past earnings and years of work, not to fluctuating asset prices.

The Ball Plan

Robert M. Ball, a former commissioner of the Social Security Administration, would restore projected long-term balance by raising revenues and cutting benefits modestly, as well as by diversifying the assets held by the trust fund reserves. Roughly half the projected long-term deficit would be closed by investing a portion of trust fund reserves (up to 40 percent by 2015) in the stock market.

Benefit adequacy and equity. The Ball plan would provide larger benefits than any of the other plans described, save the Feldstein plan. Vulnerable groups would be well protected.

Protection against risk. Because this plan would rely exclusively on defined-benefit pensions, it would spare workers exposure to the risks inherent in individual accounts. Annual cost-of-living adjustments would protect against inflation. The weakness of the Ball plan is that it does not solve the Social Security fiscal imbalance for the long run. The modest changes it proposes would allow Social Security to fall out of close long-run actuarial balance. We think current public distrust of the retirement system and of government in general makes it vital to adopt reforms that will restore financial balance and sustain it.

Administrative efficiency. The Ball plan would maintain the current low-cost administrative structure for taxes and benefits. Small added costs of investing trust fund reserves in equities should amount to no more than 1/100 of 1 percent of funds invested.

SOCIAL SECURITY	
REPORT CARD	
Criteria	Grade
Adequacy, equity, and a fair return	C
Protection against risk	C
Administrative efficiency	C-
Increased national saving	B-
Overall grade	C+
THE BREAUX-GREGG PLAN	

annuity to ensure that the annuity, plus the reduced Social Security benefit, would meet a minimum retirement income standard. The balance of the individual account could be withdrawn as needed by the retiree. A minimum benefit would be established equal to 60 percent of the poverty threshold for those with 20 years of covered earnings, rising to 100 percent of the poverty threshold for those with 40 years of earnings. A fail-safe mechanism would automatically keep the program in long-term balance.

Benefit adequacy and equity. The assured element of pension protection would be drastically curtailed under the Breaux-Gregg plan. Large Social Security benefit cuts are necessary because the plan would divert payroll taxes from Social Security into the individual accounts.

Protection against risk. The market risk of individual accounts would be moderate because investments would be limited to a few centrally managed index funds. The guaranteed minimum benefit would provide some protection to low earners if returns from their individual accounts turned out to be subpar, though over time productivity growth will push up real

SOCIAL SECURITY	
REPORT CARD	
Criteria	Grade
Adequacy, equity, and a fair return	A-
Protection against risk	B+
Administrative efficiency	A
Increased national saving	C+
Overall grade	B+
THE BALL PLAN	

National saving. Because the Ball plan would both cut benefits and raise taxes only modestly, it would have little effect on national saving.

The Aaron-Reischauer Plan

Our own plan relies exclusively on a defined-benefit retirement system. It would cut benefits by about 8 percent on the average to boost reserve accumulation and raise national saving.

The plan's distinctive characteristic is the creation of a new Social Security Reserve Board, modeled on the Federal Reserve Board, that would manage all financial operations of Social Security. With multiple institutional safeguards in place to insulate the SSRB from political pressure, the board would invest Social Security reserves in excess of one and one-half year's benefits passively in a broad mix of private securities.

The operations of the SSRB would be removed from the budget presentations of the executive and legislative branches. Budget resolutions enacted each year to guide congressional action should exclude Social Security from aggregate totals.

Benefit adequacy and equity. Although our plan reduces benefits more than the Ball plan does, it does not cut pensions significantly for vulnerable groups such as the disabled. It would boost benefits for most surviving spouses. The new strategy for investing Trust Fund reserves would bring to people dependent on public pensions the higher yields made possible by a broad portfolio of public and private bonds and stocks.

Protection against risk. Our plan preserves the

key advantage of defined-benefit pension plans by spreading risks broadly among the general population. Benefits would remain fully protected from inflation. The plan more than closes the long-term deficit, thus reducing uncertainty about future adjustment. It also incorporates a mechanism that would help to ensure that if the reformed program were ever to fall out of long-run actuarial balance, policymakers would enact corrective measures.

Administrative efficiency. Our plan maintains all the efficiencies of the current system.

National saving. Our plan would add moderately to national saving. It would isolate Social Security surpluses from the general budget process so that they are more likely than under the current budget rules to add up to national saving.

No Straight A Grades Here

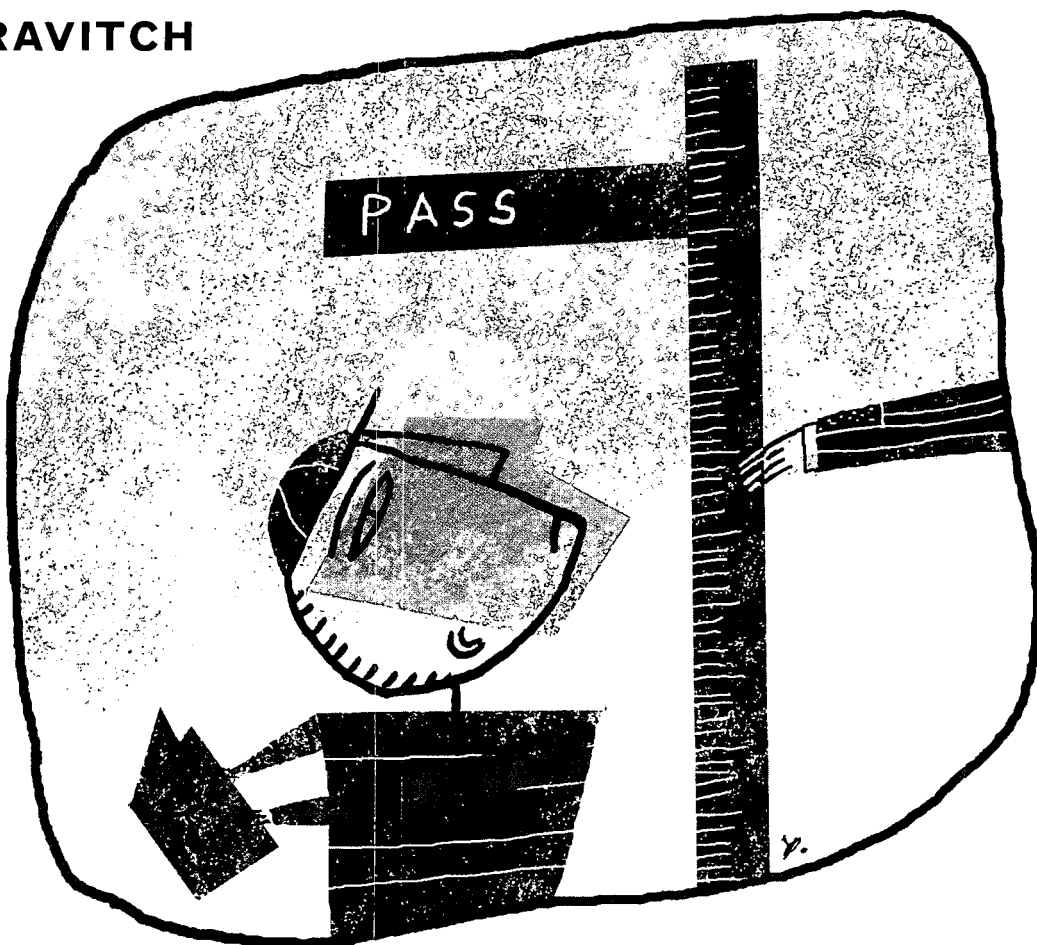
No perfect way exists to reform the nation's mandatory retirement program. No plan, including our own, that cuts benefits or raises taxes merits a straight A grade. While investing Social Security's growing reserves, collectively or through individual accounts, in assets that have higher yields than government bonds can help, it cannot alone close the projected deficit. To finish the job, future retirees will have to accept smaller benefits than those promised under current law or future workers will have to pay higher taxes. The weightlifter's maxim, "no gain without pain" applies also to pension policy. The question is whose gain and whose pain? ■

SOCIAL SECURITY	
REPORT CARD	
Criteria	Grade
Adequacy, equity, and a fair return	B+
Protection against risk	A
Administrative efficiency	A
Increased national saving	B+
Overall grade	A-
THE AARON-REISCHAUER PLAN	

STUDENT PE

BY DIANE RAVITCH

THE NATIONAL AGENDA IN



James Yang

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This article is drawn from the author's chapter in Setting National Priorities (Brookings, forthcoming).

For more than 30 years, the primary goal of U.S. federal education policy has been to ensure equality of educational opportunity. The creation of programs like Title I, Head Start, and bilingual education in the 1960s and special education for handicapped children in the 1970s directed federal resources to children who had been poorly served by the nation's state- and locally based education system.

If measured by the goals of removing legal barriers and providing equality of access, federal policy has been successful. Now federal education policies must attach the highest priority to strategies that boost student performance for all groups.

EDUCATION

PERFORMANCE

The State of Student Performance

It comes as news to no one that U.S. student performance is lagging. The federally funded National Assessment for Educational Progress (NAEP), the nation's only measure of academic achievement that tests representative national samples, has been tracking performance over the past few decades. From 1969 to 1996, according to NAEP, 9-year-olds made significant gains in science, but 13-year-olds showed no change, and 17-year-olds lost ground. In mathematics, from 1973 to 1996, students at ages 9 and 13 showed improvement, but the performance of 17-year-olds was unchanged. In reading, from 1971 to 1996, scores improved for children aged 9 and 13, but not for the older group. In writing, tested from 1984 to 1996, performance was flat for the two younger groups and declined for the 17-year-olds.

In addition to long-term data, NAEP reports student performance in relation to standards, or achievement levels (identified as "basic," "proficient," and "advanced"), that describe what students in grades 4, 8, and 12 *should* know. The most recent NAEP report shows far too many American students falling below even "basic" academic achievement. In reading, for example, 40 percent of fourth-grade students score below basic; in mathematics, 38 percent of eighth-graders are below basic; in science, 43 percent of twelfth graders are below basic. Shockingly, the scores of black and Hispanic students at age 17 are equivalent to those of 13-year-old white students in every academic subject.

The NAEP surveys are a reminder of one critical federal role in education—providing accurate statistics and assessments. But how, in an educational system rooted in state and local authority, can the federal government move beyond *assessing* student performance to *improving* it?

The State of Teacher Quality

Any effort to improve student achievement must begin with an appraisal of teacher qualifications. Students are unlikely to be high achievers unless their teachers are knowledgeable in the subject they are teaching. Yet many teachers, particularly in mathematics and science, are teaching "out-of-field"—that is, without either a major or a minor in their main teaching assignment. In 1994, 36 percent of the nation's public school

teachers (42.8 percent of private school teachers) were teaching out of field. In schools where more than 40 percent of the students are low-income, nearly half the teachers are out-of-field.

The source of the problem is the lax standards—in most states—for entry into teaching. Indeed, according to the National Commission on Teaching and America's Future, "States pay more attention to the qualifications of veterinarians treating the nation's cats and dogs than to those of teachers educating the nation's children and youth."

What can the federal government do to see that every classroom has a well-educated teacher? It should certainly *not* pump more money into traditional teacher education programs, which pay far too little attention to mastery of subject matter. It *should* focus on helping all future teachers, even those who plan to teach in elementary school, acquire command of academic fields. For example, it should offer incentive awards to states that require subject-matter examinations of future teachers. The National Science Foundation and the National Endowment for the

Humanities should also develop model examinations for states to use to assess teachers' subject matter knowledge at different levels.

Reforming the Governance of Education

In an effort to shift away from bureaucratic, top-down management of education by local school boards, many states and school districts are experimenting with alternative forms of school management—charter schools, contract management, and vouchers. Supporters hope that these new programs will help target public funds to actual instruction rather than to multiple layers of administration. None of the initiatives has been tried long enough to permit a definitive judgment about its effect on student achievement.

Charter schools are public schools that agree to meet certain performance standards in exchange for exemptions from most regulations other than those governing health, safety, and civil rights. Charter schools accept accountability for results in exchange for autonomy in how those results are produced. State legislation determines how charters are granted, what standards must be met, whether teachers must be certified, and whether existing public schools may convert to charter status.

How, in an educational system rooted in state and local authority, can the federal government move beyond assessing student performance to improving it?

If a charter school fails to meet its educational and fiscal commitments, it may lose its charter—in sharp contrast to regular public schools, which may produce poor educational results for years without any penalty. More than 1,000 charter schools are in operation today, many in Arizona, California, Colorado, Texas, and Michigan. The primary opposition to charter schools has come from local school boards, which see them as unwelcome competition, and from teachers' unions, which want to protect collective bargaining agreements.

Another form of restructuring is contract management of public schools. Paul T. Hill, Lawrence C. Pierce, and James W. Guthrie have argued that virtually all public schools should be managed by contract, with the local school board

selecting managers and leaving them free to meet agreed-upon standards. In recent years, private contractors have assumed the management of some charter schools and also formed partnerships with school districts to manage one or more regular public schools. In 1997–98, the Edison Project was managing 25 public schools in 8 states and 13 cities, with most boasting achievement gains and long waiting lists. Today Edison is managing 51

schools. Some states prohibit contract management of instructional services. Public employee unions fear that outsourcing any public-sector activity threatens their jobs.

The third important local innovation is vouchers. Two programs, one in Milwaukee (since 1990) and another in Cleveland (since 1996), supply publicly funded vouchers to low-income students. The aim is to provide an option for students who are at maximum risk of educational failure. The concept of vouchers for poor kids arouses intense opposition in some quarters, particularly from public employee unions, but also because of constitutional concerns about the participation of religious schools. In Milwaukee, students in the voucher program may enroll in both nonsectarian and religious private schools; the program has been the subject of prolonged legal battles, but it was approved by the Wisconsin Supreme Court in June, and in November the U.S. Supreme Court declined to hear a challenge to that ruling. In

Cleveland, students may also attend both nonsectarian and religious schools; the inclusion of religious schools was barred by an appellate court, but the program remains in effect while the case is on appeal.

The academic effect of the voucher program in Milwaukee is hotly debated (the Cleveland program is so new as to make evaluation all but impossible). The state-appointed monitor in Milwaukee has found no improvement, but independent analysts have reported marked academic gains. Definitive judgment will require more time.

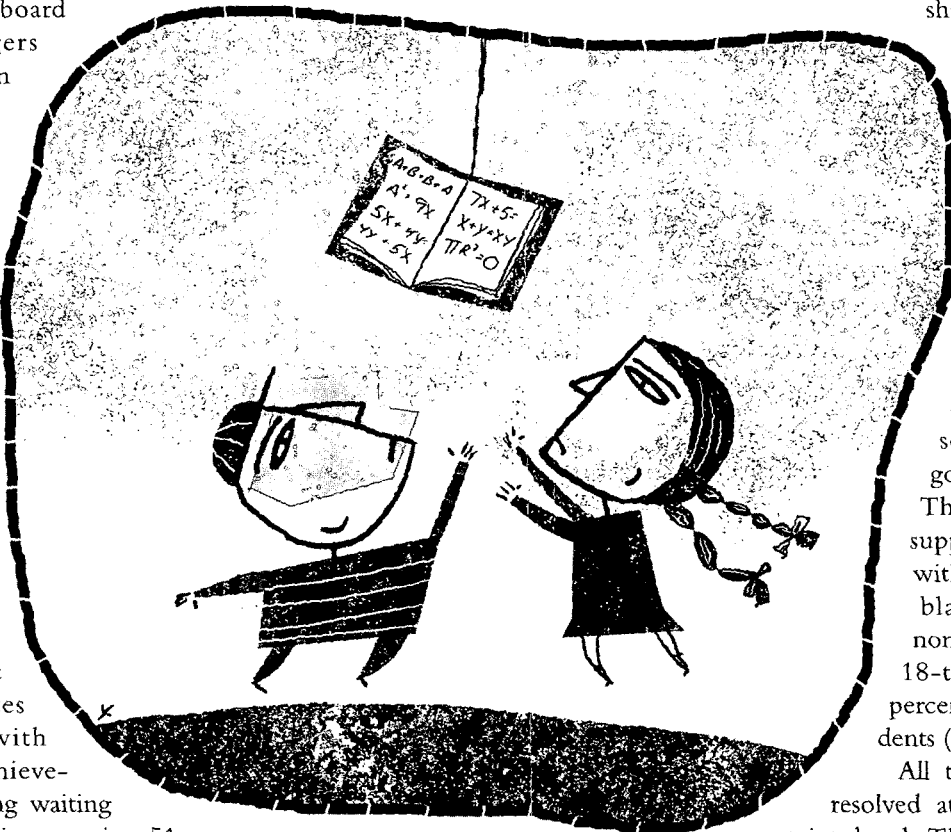
On one issue there is no debate: public opinion is shifting to vouchers. The Phi Delta Kappa/Gallup Poll reported in September 1997 that opposition to vouchers has

sharply declined over the past five years, from 74 percent to 52 percent. Public opinion was evenly divided when people were asked whether they favor or oppose “allowing students and parents to choose a private school to attend at government expense.” Those most likely to support private choice with public funds were blacks (72 percent), nonwhites (68 percent), 18-to-29-year-olds (70 percent), and urban residents (59 percent).

All these issues must be resolved at the state and district level. The federal government, however, can help states do what

they are trying to do and, at the very least, remove federal impediments. An important way to support reform without predetermining any particular result would be to change funding formulas for federal programs like Title I, special education, and bilingual education, so that the money follows the student, as it does in higher education, to any accredited institution. If a state or district prohibits charter schools, contracting, and vouchers, federal dollars would follow students to their regular public school. If a state or district establishes any of these approaches, the federal dollars would follow students to the school of their choice.

A small but substantial (\$80 million) federal program channels funds to states to encourage the start-up of new charter schools (once a school is launched, regular public funding should be adequate to its needs). This program would be improved by refusing funds to states without charter schools.



James Yang

Oregon, for example, has received millions of dollars from the charter program without even passing a charter school law.

As for vouchers, the federal government should support a 5- to 10-year demonstration program for low-income students in at least 10 hard-pressed urban school districts. The program should be limited to public school children eligible for the federal free-lunch program. The scholarship should be equal to the average per-pupil expenditure of the district plus any additional funds (Title I, special education) to which the student is entitled. Any school accredited by the state should be eligible to receive scholarship students. A large-scale federal demonstration program, carefully monitored and evaluated, would resolve debates that have been deadlocked by politics and ideology.

The Need to Reform Categorical Programs

The largest categorical federal programs—Title I, special education, bilingual education, Head Start—were created to provide equality of educational opportunity. All were established with high hopes, but none has lived up to the expectations of its sponsors. All are ripe for reform.

Title I, now budgeted at \$8 billion a year, distributes federal funds to districts with large numbers of disadvantaged students. Congress has long insisted on spreading Title I funding as widely as possible, thus assuring its political viability but reducing the money available to districts with the largest number of poor students. Backers of Title I expected it to narrow the large gap in achievement between poor children and their more advantaged peers, but evaluations in the past three decades have all concluded that Title I has failed to meet that goal. In the main, the added funds have simply not made much difference. Unfortunately, neither the program nor the evaluations were designed to identify the methods or applications that are most effective in improving the academic performance of poor children.

Title I's most striking product, the result of three decades of federal regulations, procedures, and mandates, is its unwieldy bureaucracy. The most direct way to reform Title I—and cut its bureaucracy down to size—would be to convert it to a portable entitlement, available to its intended recipient for educational services. The money should follow the eligible student to the school or tutor of his choice. The fundamental principle must be that the federal money is allocated to benefit needy children, not to sustain a host of redundant administrators.

When the Individuals with Disabilities Education Act (IDEA) was enacted in 1975, there was a clear need to protect the right of physically and mentally disabled children to receive free public education. At the time, an estimated one

million children were excluded from public schools because of their disabilities. But while special education has grown apace, it has not lived up to its initial hopes of educating disabled children.

Today, more than five million children are enrolled in special education at a cost to the federal budget of \$4.8 billion a year—and at a national cost of some \$60 billion. Though Washington funds less than 10 percent of special education, it imposes extensive, minutely detailed mandates on states and districts.

Children described as “learning disabled”—a porous category that lacks any precise or objective definition—now make up about half of all children in special education. Concern is growing about spiraling costs, the inflexibility of federal regulations, and the growth of an unaccountable bureaucracy. Of even greater concern is that special education ill-serves many of the children it is supposed to benefit. After spending nearly a year interviewing students, teachers, parents, and lawyers involved in special education, John Merrow found that only 44 percent of the children graduate from high school and that most children with learning disabilities in special education show “no signs of improvement.”

Congress and the administration are reluctant to overhaul special education for fear of offending advocacy groups for children who are deaf, blind, autistic, retarded, or otherwise deserving of special help. In view of the political problem, the best hope for reform is for the administration and Congress to create a special commission removed to the maximum extent possible from the political pressures of advocacy groups, much like the commission that oversaw the closing of U.S. military bases.

The Bilingual Education Act, passed in 1968 to help Hispanic children learn English, has suffered a fate similar to Title I and special education. Although its federal appropriation has grown ever larger—\$354 million in 1998—the program has not succeeded in teaching English to non-English-speaking children.

The key problem has been the preponderance of “bilingual” classes that have been offered in Spanish, not in English. Given that the purpose of bilingual education is to teach English to children who are “limited-English-proficient” and given that competency in English is a prerequisite for success in U.S. education and in the modern economy, the federal program should declare that its goal is rapid, full English proficiency, not bilingualism, and be recast as the English-Language Literacy Program. If the program remains intact, Congress should at least require that no child be assigned to a non-English-language program without explicit parental consent.

Head Start was launched in 1965 as a summer program for half a million disadvantaged preschoolers. Its proponents claimed that a year or two in Head Start would wipe out the

The large categorical federal programs were created to provide equality of educational opportunity. All were established with high hopes, but none has lived up to them.

cognitive gap between poor children and their middle-class peers. But evaluators reported in 1969 that cognitive gains produced by Head Start were small and temporary.

Nevertheless, Head Start became immensely popular, and its role expanded. Now it provides health, nutrition, social, and psychological services for poor children, as well as employing many of their parents as teachers and aides. In 1998, Head Start served 840,000 children and received appropriations of \$4.4 billion.

Head Start should return to its goal of cognitive development. The cumulative evidence from programs like the Perry Preschool in Ypsilanti, Michigan, suggests that a high-quality program—unlike what is ordinarily offered in Head Start—can make a long-term difference on achievement, high school graduation, and socialization.

As a federal—not state or local—program, Head Start could become a testing ground for high educational standards. Federal officials could develop a curriculum, focused on school readiness, without fear of intruding on state and local responsibility. They could set rigorous and uniform standards for what both teachers and children should know and be able to do. Such a reform would require larger appropriations, higher salaries, and a well-trained staff. But if a high-quality Head Start program could improve academic performance and graduation rates and reduce referrals to special education, it would have an even stronger political constituency and would generate enormous savings in later years.

All these federal programs have stakeholders who will fight to maintain the status quo. But if we are serious about equal educational opportunity, then public officials must be willing to make whatever changes will enable these programs to achieve the purpose for which they were created.

Standards and Assessments

Improving academic performance across the board and reducing the gaps among different groups of students require clear academic standards and good tests of student performance in relation to those standards. Through the Goals 2000 program, initiated by the Bush administration and carried on by the Clinton team, the federal government encouraged states to develop academic standards and tests based on those standards. The quality of the states' standards and tests, however, varies widely, as can be seen by comparing state performance standards in eighth-grade mathematics and those reported by NAEP. In Georgia, for example, 83 percent of seventh and eighth graders were proficient in mathematics, yet only 16 percent met NAEP's standard for proficiency; in Maryland, the

gap was 48 vs. 24; in North Carolina, it was 68 vs. 15. Only in Delaware and Kentucky were state proficiency standards as rigorous as NAEP's. The National Governors Association and business leaders are currently working to help states improve their standards and tests through Washington, D.C.-based Project Achieve.

The federal government can also help—and without interfering with the role of the states in setting education policy. In his State of the Union address in 1997, President Clinton proposed establishing voluntary national tests of fourth-grade reading and eighth-grade mathematics. Later that year,

Congress directed that the tests be aligned as much as possible with NAEP and turned control of the test over to NAEP's governing board. Unfortunately, a large bloc in Congress opposes the tests, and their future is uncertain. Large majorities in every opinion poll support the idea. Parents want to know how their children are doing, and the federal government is the likeliest sponsor of a national test.

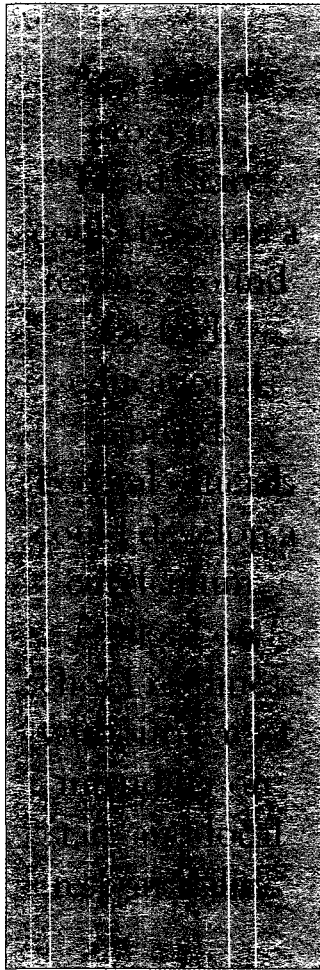
Congress should also permit school districts and schools to administer NAEP on a districtwide or schoolwide basis, if they wish to compare their performance to NAEP standards. States should be encouraged to “embed” NAEP test items into their own tests to see whether their standards are as rigorous as NAEP standards. States could thus maintain control over their own tests, but calibrate them—if they choose to do so—to the NAEP standards.

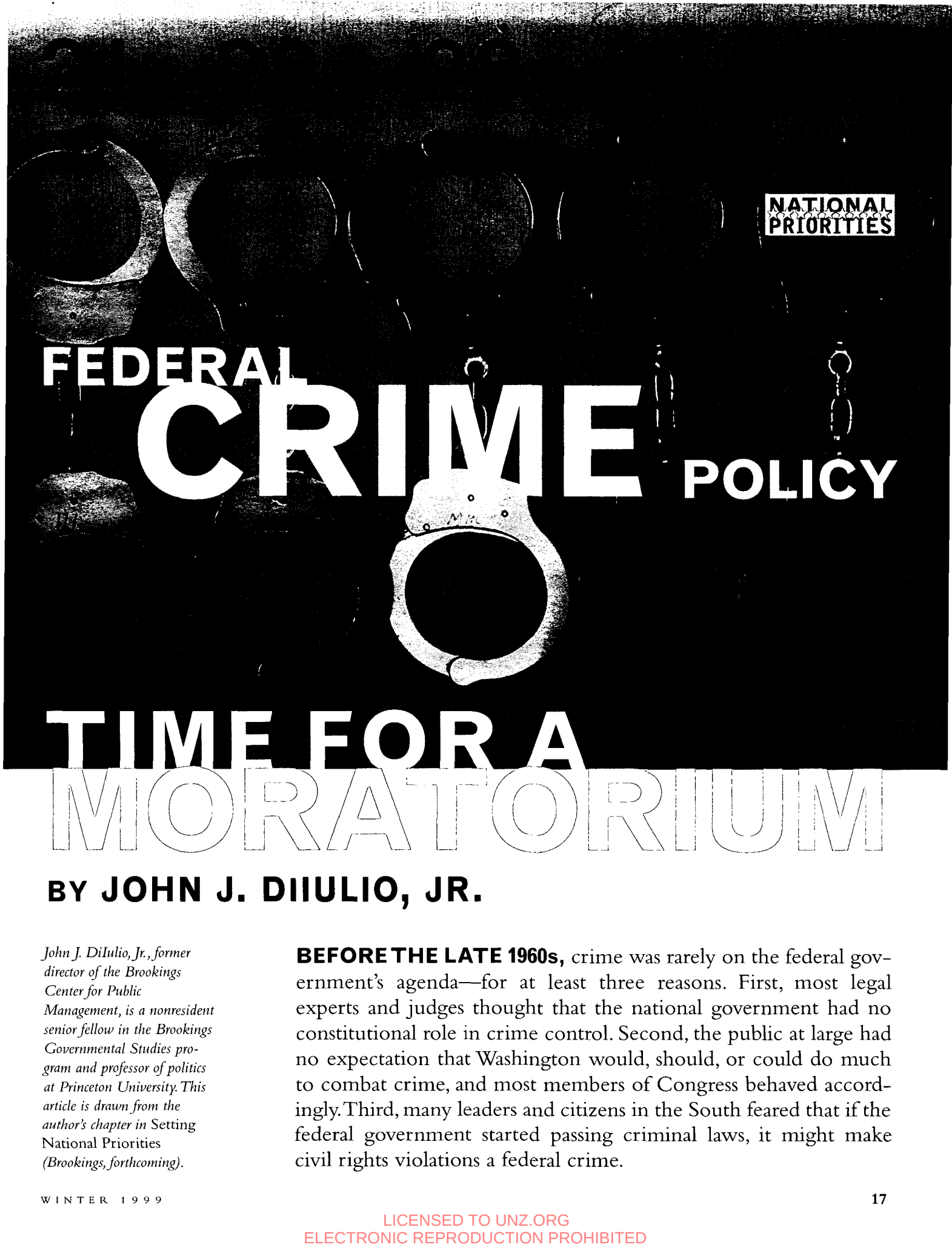
Federalism in Education

President Clinton's active interest in education has made the public aware of the crucial role of education in securing individual opportunity, economic growth, and social progress. The increased emphasis on education inevitably brings stresses and strains on our complicated federal system. What is the federal role in an education system run by state and local governments?

That there should be equality of educational opportunity—an ongoing federal priority—is not an open issue. Other questions are harder to resolve. How are we to create the conditions that allow equality of opportunity? How are we to establish programs that encourage excellence? Which level of government should do what? How should we change programs that are ineffective but that have many stakeholders?

At present, American education is mired in patterns of low productivity, uncertain standards, and lack of accountability. Federal education programs have tended to reinforce these regularities by adding additional layers of rules, mandates, and bureaucracy. The most important national priority must be to redesign policies and programs so that education funding is used to educate children, not to preserve the system. ■





NATIONAL
PRIORITIES

FEDERAL CRIME POLICY

TIME FOR A MORATORIUM

BY JOHN J. DI IULIO, JR.

John J. DiIulio, Jr., former director of the Brookings Center for Public Management, is a nonresident senior fellow in the Brookings Governmental Studies program and professor of politics at Princeton University. This article is drawn from the author's chapter in Setting National Priorities (Brookings, forthcoming).

BEFORE THE LATE 1960s, crime was rarely on the federal government's agenda—for at least three reasons. First, most legal experts and judges thought that the national government had no constitutional role in crime control. Second, the public at large had no expectation that Washington would, should, or could do much to combat crime, and most members of Congress behaved accordingly. Third, many leaders and citizens in the South feared that if the federal government started passing criminal laws, it might make civil rights violations a federal crime.

Over the past three decades, all three of these barriers to an expansive federal role in crime control have fallen. After the late 1960s Washington's role in crime grew as the power to regulate interstate commerce was more broadly interpreted by the U.S. Supreme Court. For example, the Consumer Credit Protection Act of 1968 made loan sharking (loaning money at exorbitant interest rates and enforcing repayment by the threat of force) a federal crime. When this law was challenged, the Supreme Court ruled that even if loan sharking was a purely local activity, it might "affect" interstate commerce, and so Congress was free to regulate it. By the early 1990s, more than 3,000 activities had become federal crimes, and federal judges had hundreds of state and local criminal justice agencies, especially state prisons and local jails, responding to their orders on matters of policy, administration, and finance.

Second, since the late 1960s, crime has consistently been a top public concern, and elected leaders at both ends of Pennsylvania Avenue and in both parties have campaigned and governed accordingly. During the Johnson administration, the President's Commission on Law Enforcement and Administration of Justice declared, "Warring on poverty, inadequate housing, and unemployment is warring on crime," and recom-

mended more than half a dozen new federal law enforcement and prevention efforts. After defeating Hubert Humphrey in a campaign that made "law and order" a key issue, Richard Nixon appointed "law and order" attorneys to the Justice Department and increased federal spending on anti-drug law enforcement and prevention. During the 1980s, Congress passed at least one new crime or drug control bill every two years. For example, the sweeping Anti-Drug Abuse Act of 1988 created the Office of National Drug Control Policy (commonly known as the "drug czar"). The Crime Control Act of 1990 newly federalized or beefed up federal action against scores of criminal activities, from international money laundering to selling drugs in or near local schools. The Violent Crime and Law Enforcement Act of 1994 expanded the federal death penalty, mandated life imprisonment for federal criminals convicted of three violent offenses, banned certain assault weapons, and authorized \$8 billion to hire 100,000 more police officers, \$8 billion to build prisons for state offenders, and \$7 billion for crime prevention.

Third, since the late 1960s, state and local leaders and members of Congress from the solidly Republican South, the nation's most conservative region on crime and many social issues, have gone from being brakes to



bulldozers on federal crime policy. The pro-death penalty governor from Arkansas who came to Washington in 1992 with a domestic policy blueprint that pronounced crime a policy domain in which "no federal role is justified" pushed hard for the Brady Handgun Violence Act of 1993 and the Violent Crime Act of 1994. Speaker of the House Newt Gingrich of Georgia and other key members of the sons-of-the-South-led 104th Congress talked devolution, but the "Taking Back Our Streets" provision of their Contract with America represented a \$20 billion widening of the federal role in crime control, and the crime block grants they eventually adopted expanded Washington's reach in making, administering, and financing crime policy.

Since 1995, the crime policy debate in Washington has taken shape largely around four Republican proposals. The first three—restricting the role of federal judges in directing state prisons and local jails; increasing funding for states that adopt and enforce tougher sentencing practices in cases involving adult felons convicted of multiple violent crimes; continuing the 30-year-old war on drugs—were passed by the 104th and 105th Congresses and signed into law by President Clinton. The fourth proposal—giving the federal government a major role in assisting state and local governments that (in the language of one 1995 Senate proposal) "identify violent and hard-core juvenile offenders and treat them as adults"—has provoked three years of ideologically charged and highly partisan debate but has eluded final action.

Public Concern Keeps the Focus on Crime

Crime is sure to stay on the federal agenda. Even as crime rates fall nationally, crime and drugs remain a top public worry. In a mid-1997 CNN-Time Magazine poll, crime was cited as "the main problem facing the country today" by 14 percent of respondents, tied with "lack of morals, values," and followed by budget deficit (10 percent), drugs (9 percent), education (6 percent), and, near the bottom of the list, "taxes, high taxes" (3 percent) and health care (2 percent).

Some argue that the public's continued concern about crime at a time of falling crime rates mirrors misunderstanding bred by a steady diet of "if it bleeds, it leads" journalism and media hype. Others point out that, despite the drop in crime rates, most Americans, especially minority citizens and their children living in central city neighborhoods, remain more likely to be victimized by crime today than they were decades ago when crime first became a national issue.

Still others stress that whatever crime rates do, the contemporary public's concerns about crime reflect its doubts about how committed criminal courts really are to protecting the public, combined with deep discontents about being the first generation of Americans to routinely condition everyday decisions, and to devote ever-increasing shares of disposable income, to making the places where they live, work, play, shop, or attend school relatively impervious to crime.

Theories abound about why crime has gone down. Some cite changes in policing strategies and tactics (for example, New York's quality-of-life policing initiative and dramatic citywide drops in murder and other crime). Others highlight shifts in drug markets, especially the demise of crack cocaine on inner-city streets. Still others cite demographic decreases in the number of young males or improved economic conditions or carrot-and-stick anti-violence efforts undertaken via police-probation partnerships with community and church leaders (as in Boston) or packed prisons, or even, alas, federal crime policies (for example, the Brady bill or "100,000 cops").

Strictly speaking, and with all due deference to the chief lesson of all social science and policy analysis ("It's a multivariate world!"), it cannot be "all of the above." For example, New York-style policing is one story, but murders have also plummeted in several big-city jurisdictions (Los Angeles, to name one) where no such policing innovations have been made, as well as in those (Boston chief among them) that have followed a targeted community-based approach focused on gun-related youth violence in a few high-crime neighborhoods rather than a citywide, saturation policing model. Neither crack cocaine nor drug-selling, gun-toting street gangs have disappeared entirely or everywhere. Such data as we now have give only highly variable and highly state-specific answers to the question of what, if any, fraction of the decrease in crime rates has been due to increased imprisonment.

Politically, however, it matters little how and whether the public's ongoing concern with crime is justified, and even less what criminologists conclude about the causes of changing crime rates. Federal officials will continue to respond to the public's sense of the real and perceived threat of crime and to its moral demands against persons, adult or juvenile, who murder, rape, rob, assault, steal, and deal deadly drugs. It would be unrealistic, therefore, to call on federal lawmakers to turn the crime policy clock back to the days when the national government was hardly even a junior partner in law enforcement and corrections.

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It is, however, appropriate to encourage federal lawmakers to resist, and in some areas to begin to reverse, the trend toward federalizing crime prevention and control in this country. The 106th Congress should declare a moratorium on federal crime policy, and the White House should comply. Thirty years after the first omnibus federal crime package was passed, members of the next Congress would be well advised to ponder the areas, if any, where the federal government has a real comparative advantage in crime prevention and control; explore new crime-fighting technologies and new community-based strategies; stop getting out ahead and start getting back behind state and local crime policy initiatives; and cease questioning the motives and morality of those whose views on crime and punishment differ from their own.

Federal Crime Policy: What Next?

My own view of 30 years of federal crime policy is that in some areas—for example, developing national data-gathering and information systems that enable us to measure criminal victimization and assist state and local justice officials—the federal government has made tremendous strides since the late 1960s but needs to do far more and far better. In other areas—for example, helping to stiffen state sentencing policies against adult violent offenders—the federal government has done some good but done enough. In still other areas—for example, anti-drug enforcement—it initially did some good but needs to reverse field and cut back toward treatment. And in a few important areas—for example, handling juvenile criminals—the federal government, while focusing public attention on a serious crime threat, has in recent years been on the verge of transgressing the bounds of both constitutional propriety and policy sanity. Let me briefly illustrate my reasons for each of these calls.

Counting Crime Victims

Thanks to federal policy initiatives and the work of Justice Department survey researchers and statisticians, we know far, far more today about crime rates, patterns, and trends in this country than we did three decades ago. Even today, however, the federal government systematically undercounts criminal victimizations.

There are two main measures of crime in America. The Federal Bureau of Investigation compiles the Uniform Crime Reports (UCR) from voluntary reports by local police departments. The UCR is based on a so-called hierarchical

counting method in which only the most serious of the crimes that occur in any given reported incident are recorded. For example, if a woman is raped by someone who then steals her car, the rape but not the car theft is counted.

The other main measure of crime in America is the Bureau of Justice Statistics' National Crime Victimization Survey, which is based on an annual household survey and measures both reported and unreported crimes excluding murders. The BJS has begun to adjust for its undercount of crime. For example, in May 1995, a redesigned NCVS reported new data on criminal victimizations for 1992 and 1993, and the new method found 26 percent more crimes and 56 more violent crimes than had been counted by the old method. But even the redesigned NCVS does not count crimes against children age 12 or younger or against people in jails, hospitals, shelters, or other institutional settings. Nor does it count serial victimizations: if a woman cannot recall precisely the number of times her boyfriend beat her, the survey counts just one crime. A separate but serious limitation of the NCVS is that the data cannot be disaggregated on a city-by-city basis.

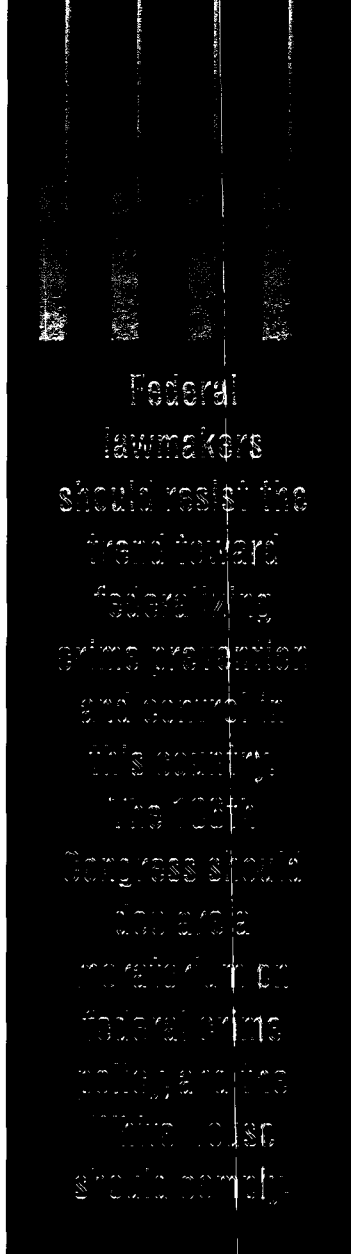
The shortcomings of federal crime data information systems offer federal crime policymakers one way to make their mark. Given greater fiscal support, public recognition, and political backing, the chronically shortchanged BJS and the FBI could devise a more complete, timely, and jurisdiction-specific measure of crime rates, trends, and

patterns in America, and provide even better assistance to state and local criminal justice agencies.

Sentencing Violent Felons

Federal efforts to strengthen state initiatives dealing with violent adult offenders and career criminals have made a demonstrable difference, but any expansion in federal fiscal support for state prisons would be hard to justify.

The Violent Crime Control Act of 1994 provided incentive grants to states that have truth-in-sentencing (TIS) laws requiring violent offenders to serve at least 85 percent of their imposed sentences. Twenty-seven states have some such laws on the books. According to a 1998 report by the General Accounting Office, federal grants were a factor in getting 15 states to adopt or enforce TIS laws. The BJS estimates that were all violent offenders nationally to serve 85 percent of their sentences in prison, newly admitted prisoners convicted of a violent crime would serve 88 months in prison on average, up from the pre-TIS averages in the low 60s. That may not sound



like much, but it undoubtedly averts lots of serious violent crimes. For example, other BJS data indicate that persons released early from prison on parole who were back in prison for a parole violation or a new crime in 1991 had committed at least 6,800 murders, 5,500 rapes, 8,800 assaults, and 22,500 robberies while under community-based parole supervision.

But no policy measure is immune to the law of diminishing returns. As Harvard's Anne Morrison Piehl and I have argued previously in these pages, it is one thing to recognize the significant crime-reduction benefits of incarcerating violent and habitual offenders, but another to insist that every convicted felon spend every sentenced minute behind bars. Federal dollars should not be used to defray the costs of administering justice in states that choose to abolish parole, whether *de jure* (by passing new laws) or *de facto* (by returning ever more parole violators to prison on petty drug charges or the like). States now spend on average just 6 percent of all their annual revenues on all state and local corrections functions. Many states are now running multi-billion dollar budget surpluses. If anything, Washington should encourage states to reinvest their own money in intensive supervision probation and parole for the roughly 4 million persons who are under supervision in the community.

Treating Drug Offenders

The 1989 report of William Bennett, the first U.S. drug czar, advised that regardless of the success of federal anti-drug efforts, "there will remain millions of individuals who need help to stop using drugs. For these reasons and more, the effective treatment of drug dependent individuals must be an important element in our overall strategy for reducing drug use in America." The report stressed the urgent need to get "more users into treatment."

The 1998 drug czar's report adopted the same urgent tone on drug treatment, noting that while treatment "can help individuals end dependence on addictive drugs," it is "available for only 52 percent of people in immediate need of it, despite a 33 percent increase in federal expenditures for treatment since fiscal year 1993."

The crux of the problem, as was noted in the 1989 drug czar's report, was and remains that "the treatment system remains largely voluntary." Research by Yale's Dr. Sally Satel and others has demonstrated the efficacy of "coerced treatment" programs of various types, but the federal government has yet to get squarely behind such programs for convicted offenders in prison, in jail, on probation, or on parole.

Handling Juvenile Offenders

In 1967, the President's Commission on Crime noted with alarm that the rate of juvenile violent crime arrests per 100,000 persons age 15–17 was 223. By 1994, violent crime arrests per 100,000 persons age 10–17 had exceeded 500. The nation's juvenile population increased about 10 percent between 1986 and 1996, while the number of crimes committed by juveniles rose 17 percent for rape, 39 percent for mur-

der, and 64 percent for aggravated assault—an explosive trend that was especially pronounced among African-American males.

As UCLA's James Q. Wilson noted in a 1996 speech in Washington, some experts "think that juveniles are immune to the justice system because they are so impulsive as to give no thought to the consequences of their actions and so reckless as not to care what the larger society thinks of them." I count myself as one who believes that some tiny but terrifying fraction of today's violent youth criminals is virtually beyond criminal deterrence. But that is a minority view among experts, and doubly so among federal lawmakers and average citizens, most of whom seem to believe that increases in juvenile violence have resulted in no small measure from policies that handle even hardened and habitual youth criminal as mere delinquents.

One thing seems clear: even with the enactment in many states of so-called get-tough youth crime laws, few juvenile offenders are ever actually "treated as adults." For example, a September 1998 report by the BJS and the National Center for Juvenile Justice indicates that from 1990 to 1994, in the nation's 75 largest counties, barely 2 percent of juveniles age 15 or older were transferred to criminal courts by judicial waiver.

As I have elsewhere argued, given the abused, neglected, and otherwise severely at-risk life circumstances of most youth who go on to become serious offenders, and given estimates that as many as 60 percent of the most serious youth criminals are never caught or convicted, it is a profound mistake to think that violent crimes by and against juveniles can be prevented or controlled simply or mainly by increasing the punitiveness of the juvenile justice system, let alone by incarcerating convicted juvenile felons in cells next to convicted adult felons. As Berkeley's Susan Estrich has argued, restraining as needed even many thousands of convicted violent juveniles in juvenile-only facilities is justifiable, but doing so while forgetting about prevention or planning prisons for preschoolers is not.

Moreover, there are now roughly 40 million children in this country under age 10, the youngest members of a record-high juvenile cohort of more than 70 million. Millions of these children are growing up materially and morally impoverished without adequate adult care and nurture. Demography need not be destiny for such facts to stir concern about the future.

Even if I believed that enhanced juvenile criminal sanctioning were both feasible and desirable, I would still recommend that, for at least the next two years, the federal government steer clear of any major changes in its juvenile crime policy regime. See whether the demographic youth bulge begins to exert any upward pressure on juvenile crime rates or whether rates continue to drop. Let the state and local governments decide, without any further federal nannying or inducements, whether, indeed, they truly wish to enforce laws of their own that "treat juveniles as adults." Alas, there may be greater wisdom in this and other state and local crime policy implementation gaps than Washington can possibly know. ■

BY MICHAEL O'HANLON

U.S. spending on foreign policy has declined about far enough. Additional cuts still planned under the 1997 balanced budget agreement would go too far. Fortunately, those cuts are likely to be rethought in light of the newfound federal budget surplus.

Defense and Foreign Policy

The Budget Cuts Are Going Too Far

The 1999 defense budget calls for spending \$270 billion—down \$50 billion from the Cold War average (and down \$100 billion from the 1980s average) in real dollar terms. In 2002, under the balanced budget accord negotiated by Congress and the White House in 1997, annual defense spending is slated to go down yet further—to \$255 billion (in terms of constant 1999 dollars). Relative cuts in international spending over the 1990s have been nearly as large as these defense cuts. The 1998 budget for development aid, support for the United Nations, U.S. diplomatic efforts abroad, and security aid to the Middle East, Bosnia, and Russia is about \$18 billion—down from an average of more than \$20 billion since the 1960s (and some \$23 billion in the 1980s). And the decline continues, with projected real spending

in 2002 of \$17 billion.

Some further reductions in the Defense Department's manpower and base infrastructure are still possible, but that does not mean that the defense budget can drop much further. Why not? Partly because we need to spend a little more on pay, spare parts, and base upkeep. But mostly because equipment purchased in large quantities during the Reagan defense buildup of the 1980s will soon wear out, putting an end to the 1990s "procurement holiday." If it does not end, the force will be less reliable, less safe, and less effective. The only question is whether to revise the balanced budget agreement right away, using some of the surplus to even out defense spending between now and 2002, or to continue the cuts and then reverse course and increase spending after 2002. Given political realities, the first course seems wiser.

Where Can the Savings Come From?

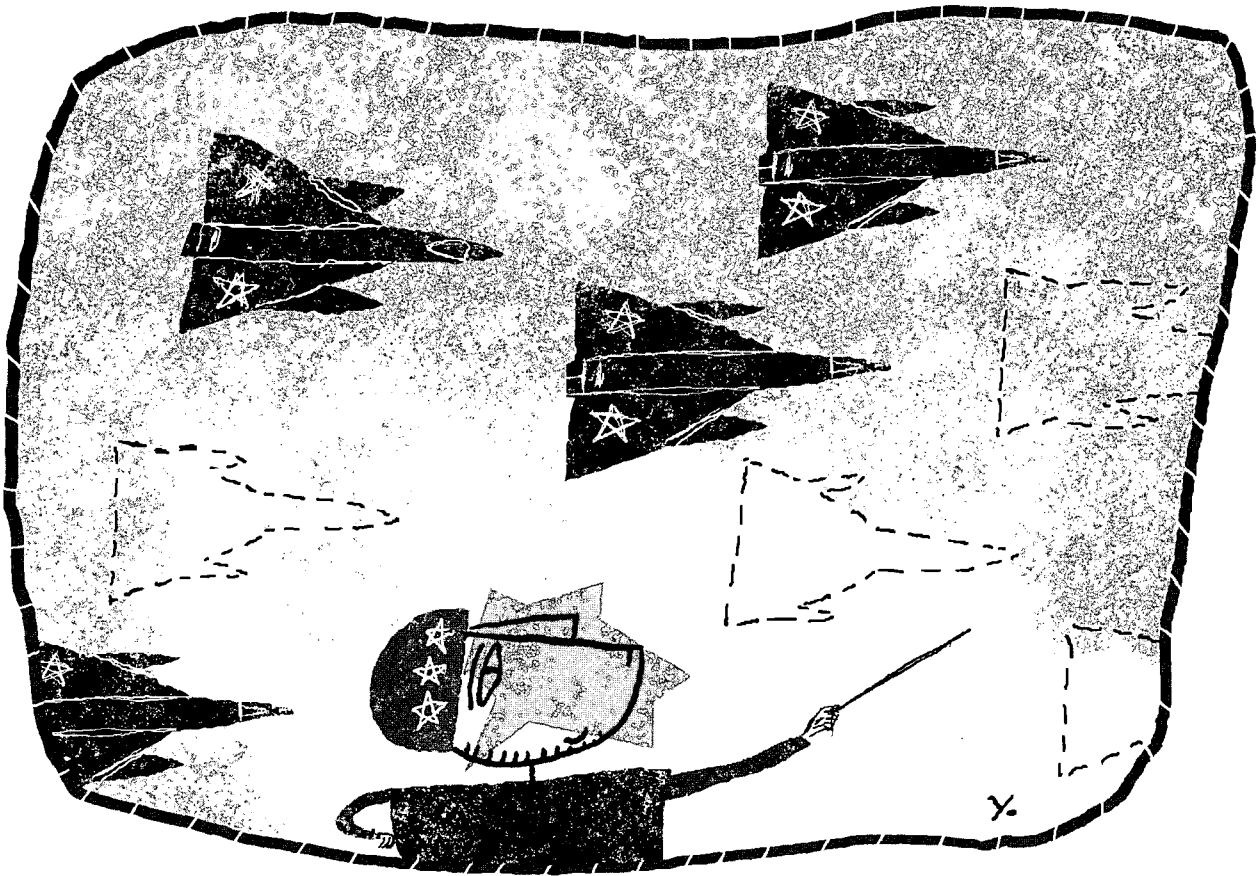
Current U.S. defense policy is based on the May 1997 Quadrennial Defense Review, which, when combined with earlier reviews, projects a cut in U.S.

forces by 2002 of fully one-third from the Cold War levels. Although the military readiness of the trimmed-down forces is still fairly good, maintaining it under tight budget conditions is not easy. Can those forces be made even leaner and more efficient without damaging their basic fabric and effectiveness? Yes, but not easily and not indiscriminately.

One place to start looking for savings is with the core of the strategy adopted in the QDR, which plans for fighting two overlapping wars, one on the Korean peninsula and one in the Persian Gulf, both against local adversaries. Although being ready for two simultaneous conflicts seems prudent, the current concept of fighting two full-fledged wars at once is both unrealistic and unnecessarily cautious.

The Pentagon scripts two simultaneous "Desert Storms"—the major offensive using half a million American troops to force Saddam Hussein's troops out of Kuwait in 1990. In this scenario, two allies are attacked at nearly the same time. Both are assumed incapable of fending off the initial assault and lose much territory in the process. Initial U.S. reinforce-

*Michael O'Hanlon is a fellow in the Brookings Foreign Policy Studies program. He is the author of *How to Be a Cheap Hawk: The 1999 and 2000 Defense Budgets* (Brookings, 1998). This article is drawn from the author's chapter in *Setting National Priorities* (Brookings, forthcoming).*



James Yang

ments over several weeks allow allied forces to stanch any further losses, set up a strong defense, and begin to weaken enemy forces through airpower and other long-range weapons. After roughly three months, enough heavy U.S. ground reinforcements arrive to permit a major ground counteroffensive to evict enemy forces and conduct a possible counterinvasion into the enemy's own territory.

A more realistic model would be a "Desert Storm plus Desert Shield" approach. Desert Shield was the initial U.S. deployment intended to protect Saudi Arabia from Iraqi attack in 1990. It involved about 200,000 troops before reinforcements began arriving in preparation for Desert Storm. Adopting a scaled-down Desert Storm plus Desert Shield approach, while also allowing some forces for places like Bosnia, would make it possible to cut overall troop levels by another 10 percent. The cuts would come primarily by reducing the size of individual units, while retaining current numbers of army divisions and air force wings to provide a base for rotating units through difficult longstanding missions, such as Bosnia, without exacerbating

their high tempo of operations. Transforming the two-war strategy allows us to make do with less military capability within each unit (though in fact today's more powerful weapons mean that there would be little loss of capability), and the 10 percent troop cut would go far to get the Pentagon out of its current budgetary straits. There are three reasons why the Desert Storm plus Desert Shield model makes sense.

First, a 200,000-strong Desert Shield force would be extremely effective in many scenarios. It could defend allied territory and key military infrastructure against virtually any armored threat the United States might face in the world today. Its airpower, nearly as large and capable as that of a Desert Storm force, could wreak havoc on an enemy's military and industrial infrastructure. Increased deployment of U.S. forces and equipment in the Persian Gulf and Northeast Asia over the past decade, combined with improved U.S. shipping capabilities, means that a Desert Shield-like force could, when teamed with allied units, probably be on site in time to prevent significant loss of allied

territory in most future conflicts.

Second, the Iraqi and North Korean military machines are notably weaker now than they were several years ago. Iraq's forces are only about half the size and strength they were before Desert Storm. North Korean armored forces are even more obsolescent than Iraq's, and their readiness has been declining with their country's economic conditions.

Third, its recent economic troubles notwithstanding, South Korea's armed forces are much improved and still getting better. Although South Korea has less armor than North Korea, its technological edge evens out the overall military hardware balance. Factoring in South Korea's excellent state of readiness gives the South net superiority over the North, in my judgment. South Korea might in fact be able to hold off a North Korean attack itself—though not for sure, since much about war is unpredictable.

Because the need for a major ground counteroffensive or the outbreak of war in a place where the United States is less prepared to respond quickly might one day necessitate another Desert Storm,

keeping the capability to unleash one such operation is critical. But planning for two overlapping Desert Storms is excessive. Scaling back that capability and reducing the size of the force a little more would save \$5 billion a year.

Weapons Purchases

As the procurement holiday draws to a close, the Pentagon will need to buy more weaponry simply to keep the force safe and reliable. Equipment procurement spending will certainly need to increase from the current \$45 billion a year. But Pentagon plans translate into likely average procurement spending of some \$70 billion a year in the next decade. Surely procurement spending will have to go up. But can that price tag be reduced?

Some analysts, claiming that we are on the threshold of a “revolution in military affairs,” insist that we must spend every penny of that \$70 billion or risk being

Experimentation with joint-service operations must be as realistic and vigorous as possible. Fortunately, existing defense plans already endorse most of these approaches and goals. But they must be preserved. The coming defense funding crunch must not squeeze out funds for R&D and experimentation and for buying promising new technologies like advanced sensors, communications, and munitions on a case-by-case basis.

One way to protect funds for R&D and key innovations is to scale back planned purchases of gold-plated major weapons platforms. Although they would be desirable, they are not critical. As just one example, the QDR cut the planned purchase of the F-22 Raptor aircraft to 339. But that is still a moderately large F-22 program. It was retained on the implicit presumption that we might need Raptors against threats like North Korea and Iraq in two regional wars at once—which strains credulity. It makes more

	Billions of 1999 dollars
1999 defense spending	270
2002 defense spending under balanced budget deal	255
2003–2015 defense spending average under QDR	285
Annual saving from changing two-war strategy	-5
Other changes (naval and nuclear forces)	-5
Annual saving from scaling back purchases of advanced major weapons systems	-10
Resulting defense spending 2003–2015	265
Needed annual increase relative to 2002 level	+10

Source: Michael O'Hanlon, *How to Be a Cheap Hawk*.

left in the high-tech dust. But what country could plausibly leave us behind in the near to medium-term future? Thus, a sober, balanced, and evolutionary approach to future defense planning seems wiser than radical measures. One key is maximizing the effectiveness of military research and development. Ample funds must also be available for targeted improvements such as unmanned aerial and underwater vehicles when technologies become mature, as well as advanced munitions, computers, and communication systems.

sense to buy enough to deploy a significant Gulf War–like air superiority force to a single future war against a potentially more capable adversary. By that logic, 150 F-22 planes (roughly the number of F-15Cs we deployed to the Gulf War for the air superiority mission) would serve. Remaining fighter requirements could be met with new production runs of those same F-15s (or modified F-16s) as old ones wore out.

Scaling back this purchase and other inessential planned purchases could save about \$10 billion a year in procurement relative to current plans. Real procurement spending would still need to increase, but to around \$60 billion rather than \$70 billion. The money could be found by making the added force cuts noted above—meaning that real defense spending would not need to go up. But neither should it go down much more, if at all.

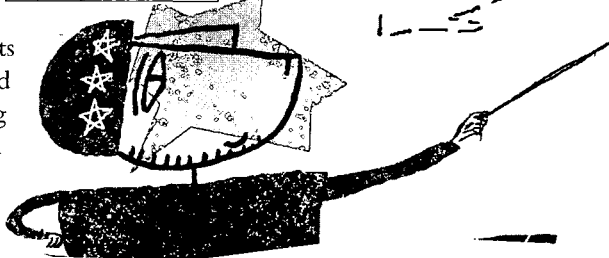
International Affairs Spending

Although some economies in international affairs spending also remain achievable, the argument is strong for restoring international spending to roughly its 1980s levels. The end of the Cold War did not substantially reduce the challenges addressed through these U.S. federal activities. The need to provide security aid to places like NATO’s southern tier and to direct international broadcasting into communist states has been supplanted by the need to support democratic and economic transitions in former Warsaw Pact regions, conduct conflict recovery efforts in places like Bosnia, and assist historically high numbers of refugees around the world.

Of the \$18 billion the United States spent on international activities in 1998, about \$9 billion was “official development assistance”—economic and humanitarian assistance, given as grants or concessional loans, for developing countries (not counting Central and Eastern Europe, but counting economic aid to the Middle East). The remainder is for aid to the formerly communist states, military aid to the Middle East, United Nations activities, U.S. diplomatic efforts, international broadcasting, and export assistance.

Many critics of official development assistance claim that we should start to phase out overseas aid as a major instrument of foreign policy. They point, for example, to the roughly \$130 billion of private capital—and about the same amount in bank loans and bonds—flowing to developing countries in 1996 (clearly, flows have declined since). With the marketplace making so many resources available, they question why aid, which totaled \$55 billion by all donors combined in 1996, is still needed. In fact, however, most developing countries do not receive much private capital from abroad, even in good times (and many do not gain a great deal from global trade either). Countries in Africa and South Asia, for example, generally receive many times less private money per capita than those in East Asia or South America.

Critics also argue that aid “does not work.” But aid has already done a good job helping to improve basic health and education indicators in the past several



decades. Aid has supported child immunizations, greater availability of rehydration salts and nutritional supplements, and provision of clean drinking water. Since 1960, these and other efforts have reduced the proportion of children in developing countries who die before reaching their fifth birthday by more than 50 percent. Partly as a result of increased availability of contraceptives, now used by 55 percent of the world's couples, the fertility rate per woman is down from 5 to 3 over that same period—a much more economically and environmentally sustainable growth rate in most countries.

It is true that, absent good economic policies on the part of developing countries, aid does not tend to spur economic growth. It can even slow growth by serving as an “opiate of the policymaking elites” and retarding the formation of a consensus for economic reform.

But it is also true that, when given to recipient governments with good policies, aid does tend to help their economies grow more quickly. Statistically, the average magnitude of the effect—above and beyond the benefits that sound economic policies themselves generate—is to increase growth rates by nearly half a percent a year relative to countries not receiving much aid, which adds up over time. So we should reduce aid to some countries with bad policies—but increase it significantly for many of those bent on reform.

Why the focus on growth? Economic growth is the surest way to alleviate poverty dramatically, as evidenced most notably in East Asia over the past several decades (recent setbacks notwithstanding). On average, inequality does not worsen with growth, so a rising tide tends in most cases to lift all boats. In addition, increasing economic growth correlates with declining population growth. Robust economic growth and moderate population growth together appear to offer the best hope for reducing the appeal of political extremism; it is often the large numbers of unemployed and underemployed young men who provide much of the

grist for radical movements in places like the Middle East.

Aid donors, led by the multilateral organizations, have been trying to be more selective in their aid disbursements for at least a decade. But that has often meant attaching dozens of specific conditions to aid packages and demanding that recipients satisfy them in detail—an approach that tends to swamp weak bureaucracies in developing countries with red tape. Moreover, given the number of conditions, donors often continue to provide funds even when many of the most critical are not satisfied. What donors should do instead in most cases is declare that they will preferentially support countries with solid macroeconomic frameworks—low inflation rates, modest-sized public sectors, small government deficits, dependable property rights, generally open trade regimes, and reasonable exchange rates. Ample room for debate exists on the specifics, as has been made clear in the wake of the Asian economic crisis of 1997. But the need for solid core economic fundamentals is beyond dispute.

As Carol Graham and I noted in our 1997 book, *A Half Penny on the Federal Dollar*, there is a strong case for increasing total aid provided by all countries worldwide from the current \$55 billion a year to \$80 billion. Today, many poor countries that have good economic policies—and that would be likely to put aid to good use—receive far less aid per capita than development success stories like Korea and Taiwan once received. Raising the aid to these poor countries to levels comparable to those once flowing to Korea and Taiwan, while giving countries with weak economic policies only enough assistance for grassroots projects and humanitarian relief, would be more costly but likely to produce far more benefits. The added

money should go to priorities like debt relief for poor countries in Africa, increased availability of primary education as well as primary health care and family planning services, construction of infrastructure, recovery from conflicts, “social safety nets” to help the poor when countries adopt painful economic reforms, and narrowly targeted environmental programs. This global aid initiative in turn implies an annual U.S. aid increase of \$3 billion to \$4 billion.

Time for a Change

Defense and foreign affairs are the only two major federal budget categories in which spending has declined in real terms in the 1990s. They have provided as much as \$100 billion in annual deficit reduction since the end of the Cold War, ranking with tax increases and the economy's good performance as the primary causes of the fiscal balance the United States has now attained.

The rationale for significant cuts in defense spending was compelling given the end of the Cold War, but the further cuts now planned are inadvisable. In international affairs accounts, cuts have already gone too far (and are still being made).

Should the country spend some of any surplus on foreign policy? The answer is “yes.” Not a lot of additional funds are needed. But an additional \$3 billion in annual aid expenditures and \$10 billion in the yearly defense budget, relative to expenditures now planned for 2002, will be required. In fact, increases of such modest amounts would not be increases at all, but simply enough money to keep foreign policy spending steady relative to inflation.

It is often said that democracies in peacetime tend toward isolationism. That may be true, but with a few more billion dollars devoted to foreign policy in the years ahead, the United States can be reasonably confident of having the resources to maintain a foreign policy as vigorous and successful as that which won the Cold War and helped usher in the greatest waves of global economic growth and democratization in world history. ■

NATIONAL
PRIORITIES

BY I. M. DESTLER

TRADE

AT A CROSSROADS

2012

AN APPROACH FOR 2012-2013

FOR U.S. TRADE POLICY, the past quarter-century is not without irony. Its first 20 years were replete with economic troubles, real and perceived: "oil shocks" and double-digit inflation in the 1970s; the "twin deficits" of budget and trade in the 1980s; unemployment, the productivity slowdown, and stagnation in workers' take-home pay; the growing challenge from Japan. Yet over these same two decades, the United States maintained and reinforced its open-market international trade policies, with two unprecedented global agreements (the Tokyo Round and the Uruguay Round under the General Agreement on Tariffs and Trade), the North American Free Trade Agreement, and other liberalization initiatives.

In the past five years, by contrast, the U.S. economic situation has turned astonishingly rosy. Inflation and unemployment are both at or near their 25-year lows. Productivity is rising, as are workers' real incomes. The budget deficit and the Japanese threat are both history. Yet since the beginning of 1995, U.S. trade policy has been on hold. For the better part of three years President Bill Clinton sent no proposal to Congress to renew the "fast-track" negotiating authority granted to all his predecessors since Gerald Ford. When he finally did so, and lobbied hard for it in the fall of 1997, his overture was spurned. When House Speaker Newt Gingrich pressed for approval last September, the vote was negative.

Today U.S. producers and consumers are exceptionally well positioned to gain from global trade. Federal government action can enhance these gains, particularly by negotiating with other nations to achieve further mutual reductions in trade barriers. But no agenda for U.S. trade policy can be credible in 1999 unless it recognizes and takes account of the political forces that led to today's stalemate.

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Diplomatic Success, Political Stalemate

Bill Clinton inherited two landmark trade initiatives: NAFTA, signed by President George Bush in 1992, and the GATT Uruguay Round, initiated under Ronald Reagan. In an uphill battle, Clinton won congressional approval of NAFTA in November 1993—after negotiating side agreements with Canada and Mexico on labor and environmental issues. His U.S. Trade Representative, Mickey Kantor, closed the Uruguay Round deal a month later, and Congress approved its implementing legislation in December 1994.

The United States concluded 1994 with two new trade-liberalizing commitments. In November, leaders of the Asia Pacific Economic Cooperation Forum (APEC) agreed to free trade among themselves by 2010 (2020 for the less developed members). In December Western Hemisphere nations pledged to negotiate a Free Trade Area of the Americas by 2005.

The years that followed saw further progress in trade liberalization under the auspices of the World Trade Organization, the permanent global institution created during the Uruguay Round. Three new sectoral negotiations carrying over from the Uruguay Round were successfully concluded: information technology in December 1996, basic telecommunications services in February 1997, and financial services in December 1997. The WTO's Dispute Settlement Understanding also got off to a credible start. The United States became the most active complainant and won most of its cases.

The United States also remained active in bilateral trade matters, striking agreements with Japan on autos and China on intellectual property. But U.S. negotiators were undercut by the expiration of fast track, the law that allows them to make credible commitments to reduce U.S. trade barriers in exchange for market-opening commitments by U.S. negotiating partners.

Fast track is Washington's solution to a bedrock constitutional dilemma. The president and his executive branch can negotiate all they like, but Congress makes U.S. trade law. Other nations know that our highly independent legislature will not necessarily deliver on executive promises. So in negotiations where broad-ranging commitments to open markets are exchanged, they refuse to bargain seriously unless U.S. officials can assure that Congress will write their concessions into U.S. statutes. Fast track offers that assurance, with its promise that Congress will vote up or down, within a defined time period, on legislation submitted

by the president to implement specific trade agreements.

Congress first granted fast-track authority in 1974 and renewed it five times thereafter. When APEC members and the Western Hemisphere nations agreed to free trade in 1994, the prevailing assumption was that the U.S. president would be granted that authority to carry out his nation's side of the bargain. So it was also with the follow-on agenda of the WTO involving intellectual property, government procurement, and agriculture. But President Clinton will shortly enter his sixth year without fast-track authority, and near-term prospects for its enactment are not good.

The trouble began with a 1994 proposal by USTR Mickey Kantor for a broad, seven-year fast-track extension as part of the Uruguay Round implementing legislation. Building on the NAFTA side agreements and seeking to mend trade policy relations with wounded Democratic constituencies, Kantor proposed that "labor standards" and "trade and the environment" be among the seven "principal trade negotiating objectives" for which fast

track would be employed. Organized business objected vehemently, as did free-trade Republicans. Compromise was never reached, and the administration did not include fast track in the bill.

In 1995, the House Ways and Means Committee, under its new Republican chairman Bill Archer (R-TX), approved a fast-track bill. But sporadic negotiations with Kantor, centering on the labor-environment language, were unsuccessful. In early 1997 the Senate Finance Committee leadership joined its House counterparts in pressing for a White House fast-track proposal. But differences over labor and the environment had hardened. Many Democrats wanted these issues to be central to future trade negotiations; almost all Republicans took the opposite position.

The president's heart lay with his Democratic allies. And there were strong general arguments for linkage: trade undeniably affected both workers and the environment, and trade policy needed to broaden its domestic support. But the Clinton administration had been pressing these connections since it came to office and meeting strong international resistance, particularly from developing nations that saw the trade-labor linkage in particular as disguised protectionism. After postponing a decision for months, Clinton went where the votes were, toward the Republican majority. He

proposed legislation in September 1997 with severe limits on coverage of labor and environmental issues. He counted on his persuasive powers, as witnessed earlier with NAFTA, to bring victory. But despite 11th-hour, one-on-one lobbying, the president gained support from only 43 House Democrats, just 21 percent of the total.

Faced with House defeat,

Clinton asked House Speaker Newt Gingrich—a strong fast-track supporter—to adjourn for the year without a vote. Gingrich complied. But when Clinton—concerned over Democratic divisions—failed to renew his proposal in 1998, Gingrich brought it to a vote anyway, urged on by business and farm interests and Republican partisans. The result was a debacle—180 votes for and 243 against. Just 29 Democrats voted yes, and 71 Republicans were opposed.

The Current Situation

The U.S. market remains open. The U.S. economy is in exceptionally good shape, recent signs of weakness notwithstanding. But U.S. trade policy is in serious trouble. The core reason is what stymied fast track: the impact of globalization and Americans' differences about how to respond. Growing U.S. engagement in the world economy has had important effects on Americans' welfare and their economic institutions. On balance, the impact is favorable, and the flexibility and innovativeness of U.S. firms and workers augur well for the future. But anxieties are widespread.

Caught in the middle are Democrats concerned about increasing inequality in U.S. income distribution, the weakening of labor unions, and the impact of economic activity on the environment. Many see globalization as inevitable and trade as, on balance, a good thing. But they also see losers, particularly among their core constituencies, and they see weak and declining U.S. programs to help these losers. They favor strengthening the safety net at home, but they also argue for moves toward globalization of norms on labor and environmental standards. These "trade and..." issues blocked fast track in 1997, and the lines hardened when Gingrich tried to force matters in 1998.

Traditional business protectionism, by contrast, was barely visible in the fast-track fight. But a surge in steel imports has now triggered a strong industry campaign for relief, and other industries may follow. For the strength of the dollar, and the Asian financial crisis, have brought a rise in the volume of imports comparable to the unprecedented surge

of the early 1980s. Throughout the Clinton administration, the overall U.S. merchandise trade deficit has been rising: from \$131 billion in 1993 to \$198 billion in 1997 and a projected \$250 billion for 1998. Over the first two years, the actual impact on the U.S. economy was muted: the increase in the *quantity* of imports was less than the increase in *value*, as a decline in the dollar led to a modest rise in import prices. But in 1995 the dollar began rising, and since then, with import prices falling, the increased quantity of imports has been greater than the dollar figures show.

The final piece of bad news for U.S. trade policy has been the global financial crisis, compounded by the collapse of confidence in Japan. Both have shifted administration legislative attention from fast track to replenishment of IMF resources, which Congress finally granted last October.

Political and economic circumstances today are therefore less auspicious than those under which Clinton's fast-track campaign failed in late 1997. Yet the arguments remain strong for renewing the U.S. policy of leadership in international trade liberalization.

Why Trade Liberalization Still Makes Sense

The economic case for open trade begins with the gains from specialization. We trade because we can get more of the goods and services we value by devoting our energies to what we can do well and using the proceeds to purchase what others are good at making (or doing). Lowering U.S. import barriers increases opportunities to trade, and thus the gains from trade.

Trade also offers dynamic benefits by encouraging deployment of America's resources, including creative human talent, in innovative, knowledge-intensive industries, leading to increased productivity and a larger "economic pie" for distribution within the nation. A final economic advantage of U.S. trade liberalization is the leverage it provides in getting other nations to reciprocate.

The economic case for active trade-negotiating policy is particularly strong vis-à-vis countries with which we trade

substantially—those in North America, East Asia, and Europe. APEC encompasses the first two, so liberalization under its auspices offers great potential. Economic gains are maximized in global negotiations under the auspices of the WTO, simply because their successful conclusion brings substantial barrier reduction by the preponderance of U.S. trading partners.

By economic criteria, U.S. trade with the remainder of the Western Hemisphere is less critical. But trade plays a particularly constructive *political* role in U.S. relations with today's Latin America. Democratization and economic reforms have led most of those nations to reverse the longstanding priority given to "nonintervention in internal affairs" and national economic autonomy. Their agreement to a Free Trade Area of the Americas is widely viewed as the triumph of the deepening of engagement with the United States and with each other. It is a powerful source of U.S. leverage, particularly on economic issues but beyond them as well.

Trade policy also has substantial domestic political importance. The stance our government, particularly Congress, takes is a potent symbol of Americans' attitudes toward engagement in the global economy. Openness and readiness to negotiate are signs of confidence. Ambivalence and stalemate suggest pessimism about our capacity to handle the new challenges. Moreover, U.S. trade policy reflected bipartisan consensus as recently as the Uruguay Round vote of 1994. Restoring that consensus is important for effective policy in the future.

Finally, to the degree that Americans are genuinely concerned about trade's impact on social norms and conditions at home as well as abroad, international trade negotiations remain the primary means of shaping the terms of globalization. It is reasonable and proper to debate what U.S. negotiating priorities should be. But failure to engage is not reasonable, for globalization is coming, ready or not.

Breaking the Stalemate

Without fast track, President Clinton and his successor will be unable to negotiate significant new trade agreements. And their hands will be tied in their exercise of broader international economic leadership. Much of the recent argument over fast track has been symbolic, for no one can claim that important new trade-related labor and environmental understandings are available to the United States if only Congress would authorize their pursuit. Thus many in the trade policy community see these issues as a no-win diversion, a move into territory guaranteed to stir domestic controversy with little chance of international achievement. Yet trade *does* affect the plight of workers. Trade *does* affect the environment. If means are not available to address these effects, advocates of these causes will oppose trade liberalization.

At the same time, the trade agenda can easily become overloaded with "related" issues for which there is little prospect of meaningful agreement. Seeking to do everything may assure doing nothing. And for some in the labor-environment coalition, this may be the objective.

If the matter at stake were a central trade negotiation with major, visible costs to the United States for not joining it promptly, a House majority could probably have been squeezed out in 1997 or 1998. But the agenda is scattered—FTAA, APEC, WTO sectoral talks—and the costs of delay to U.S. interests are initially modest. Thus it will be difficult for the administration and its allies to win by resubmitting the old bill and "trying harder." Yet waiting until 2001 and a new presidency means two more years of U.S. trade policy weakness, of hardening ideological lines at home, of leaving the agenda and the gains to other nations or allowing the global and regional trade regimes to drift.

Bill Clinton appears to recognize all this—he has spoken repeatedly of the need to "do the hard work of building a bipartisan coalition" on trade "when Congress returns next year." What follows is a suggested approach aimed at

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winning some significant negotiating authority next year, with prospects of more thereafter.

The United States will host, late in 1999, the next Ministerial Conference of the WTO. Clinton should establish a goal of enacting trade legislation by that date. He should restate his maximum agenda—fast track under the time-tested formula, granted for a number of years, covering regional FTAs as well as global negotiations. He should negotiate a timetable with legislative leaders—a presidential proposal sometime in March, perhaps, with House action by midsummer and Senate consideration thereafter.

Most important, the president should signal his readiness to compromise on specifics by launching a dialogue with leaders on both sides of the ideological divide, including members of Congress and representatives of private organizations. This dialogue should address three central, intertwined issues: the specific negotiations to be authorized, the means for addressing the “trade and...” issues, and the means for coping with the costs of globalization. Each might be addressed by a working group organized by the administration but reaching beyond it.

A working group on the specific negotiations, for example, could be headed by the U.S. Trade Representative, Charlene Barshefsky. The current global agenda consists primarily of WTO sectoral negotiations. They have been generally less controversial than the regional agenda, where the U.S. debate has centered on NAFTA and its legacy. Until fast-track advocates in the proposed working group can make a stronger case about NAFTA than they have to date, the group would likely confirm greater support for the global than for the regional negotiations.

It is reasonable and proper to debate what U.S. negotiating priorities should be. But failure to engage is not reasonable, for globalization is coming ready or not.

The group on “trade and...” issues should be headed by a senior figure outside the administration known for sympathy for the two central concerns—labor and the environment—and for trade liberalization. The group should include representatives of the business, labor, and environmental communities who are prepared to be pragmatic about one another’s perspectives and to explore how much they might be accommodated. The hope would be to develop an action agenda for international negotiating goals and means acceptable to most Republicans and attractive to many Democrats.

A final group would address the costs of globalization to Americans who are hurt by it. Its head might be a sympathetic member of Congress or a prominent former member, such as Bill Bradley. The lack of a strong program to help the trade losers has been a major weakness in the Clinton administration’s position, for a positive adjustment policy for workers at home would respond much more effectively to their plight than any conceivable agreements on labor standards overseas. The longstanding U.S. Trade Adjustment Assistance program has lost credibility because of modest funding and perceived ineffectiveness in worker retraining. A possible alternative would be a program of

“earnings insurance” offsetting a portion of workers’ losses in pay that result from trade-liberalizing agreements.

The goal of such a dialogue is to broaden support for trade policy and address trade’s often-disruptive impacts on American society. It could lead to any one of a number of policy outcomes, from development of a narrow fast-track bill for negotiations with broad support (probably WTO sectoral), with dialogue continuing on the thornier issues; to enactment of broad fast-track authority

together with new programs for those hurt by trade and economic changes; to a law combining immediate fast-track authority for certain negotiations with an expedited procedure under which the president could seek it for others. Realistically, one would hope to build a consensus approach that would win, eventually, significant support within the environmental community and the backing of some labor sympathizers.

It would be best for U.S. trade policy if Congress were to grant comprehensive fast-track negotiating authority immediately. But this is not likely, nor is it essential. What is essential is for the president, Congress, and key societal groups to engage in a process that leads to step-by-step granting of negotiating authority as it addresses, step by step, the concerns of critics. The process must begin soon and continue through the 2000 elections. For, left to itself, the presidential primary dynamic will only make matters worse, as Democrats compete for union favor and Republicans joust for endorsement by values conservatives sympathetic to linking trade and abortion policy or trade and religious freedom.

Anxieties over globalization have brought stalemate to the U.S. trade policy agenda. But the exceptional current condition of the American economy offers an unusually favorable climate for addressing these anxieties. If not now, when? ■



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GROWING AMERICAN INEQUALITY

Sources and Remedies

BY GARY BURTLESS

Over the past two decades the United States has experienced a startling increase in inequality. The incomes of poor Americans shrank and those of the middle class stagnated while the incomes of the richest families continued to grow. The well-being of families up and down the income scale has increased over the past five years, but the average income of the poorest Americans remains well below where it was at the end of the 1970s.

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PHOTOS COURTESY OF LLOYD WOLF AND PHOTODISC



From the end of World War II until the 1970s, the percentage difference in average cash income between well-to-do and middle-class American families generally declined (see figure 1). In the 1980s the gap began to widen noticeably. Better measurement of rich families' incomes accounts for some of the apparent jump in the early 1990s, but the gap between middle- and high-income families almost certainly increased after 1992. The cash income difference between middle-income and poor families followed a similar trend. After narrowing for several decades after World War II, largely because of increased wages and improved Social Security and welfare benefits for the poor, the gap began widening in the early 1970s. The figure suggests that the trend in inequality has not been driven solely by worsening poverty among the poor or by spectacular income gains among the wealthy. It has been produced by growing disparities between Americans at every level of the income ladder.

Soaring inequality has not been confined to the United States. Rich nations around the world have seen inequality grow since the late 1970s. But the jump in income inequality has been particularly rapid in the United States—and it came on top of a higher initial level of inequality.

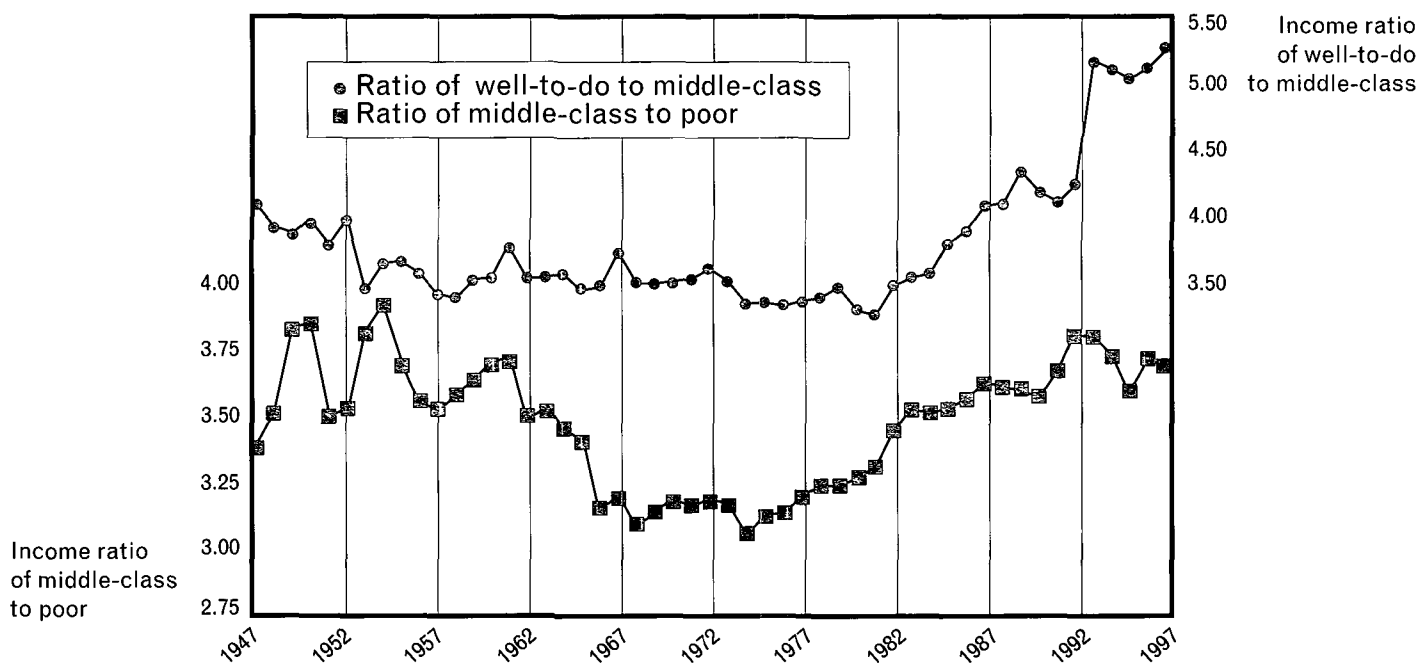
Should We Care?

Many Americans are not terribly concerned about income inequality or about the need for public policies to temper inequality. Although public opinion polls find that large majorities of residents in five European countries and Japan

believe the government should guarantee each citizen a minimum standard of living, only about a quarter of Americans agree. By and large, Americans tend to believe that people bear primary responsibility for supporting themselves. U.S. citizens are also more likely to believe their society offers an equal opportunity for people who work hard to get ahead. Given these views, why should Americans be concerned about mounting inequality?

One reason for concern is that growing income disparities may undermine Americans' sense of social cohesion. Even if they are indifferent about the abstract principle of economic equality, most Americans probably believe in the ideals of political and legal equality. But greater inequality has almost certainly produced wider discrepancies in political influence and legal bargaining power. In 1979 the income of an American at the 95th percentile of the income distribution was three times the median income and thirteen times the income of an American at the 5th percentile. By 1996 an American at the 95th percentile had an income almost four times the median income and twenty-three times the income of the person at the 5th percentile. The growing income gap between rich, middle-class, and poor and its consequences for the distribution of political influence may contribute to Americans' dwindling confidence that their elected officials care very much about the views of ordinary citizens. According to polling experts Karlyn Bowman and Everett Ladd, in 1960 only a quarter of U.S. respondents agreed with the statement "I don't think public officials care much about

Figure 1.
Trend in Family Income Inequality: Ratio of Average Incomes of Well-to-do and Middle-class Americans and of Middle-class and Poor Americans 1947–97



Well-to-do Americans are those in the top 5 percent of the income distribution. Middle-income Americans are those in the middle 20 percent. Poor Americans are those in the bottom 20 percent.
Source: Author's tabulations of Bureau of the Census P-60 Report data.

what people like me think." By 1996, the share who agreed had climbed to 60 percent.

Inequality may also affect public health. Demographers and public health researchers have found mounting though controversial evidence that greater inequality can boost mortality rates and contribute to poor health. Countries and communities with above-average inequality have higher mortality rates than countries or communities with comparable incomes and poverty rates but lower inequality. According to one public health researcher, low-income Americans have death rates comparable to those in Bangladesh, one of the world's poorest countries, even though absolute incomes, average consumption, and health care spending are much higher among America's poor than they are in Bangladesh. The possible link between public health and inequality may help explain why the United States, one of the world's wealthiest countries, does not have the longest average life span or the lowest infant mortality rate. If the benefits of U.S. income growth after 1979 had been more equally shared, the average health and life spans of Americans, especially poor Americans, might have improved faster than they did.

Defenders of American economic and political institutions correctly point out that inequality plays a crucial role in creating incentives for people to improve their situations through saving, hard work, and additional schooling. They argue that wage and income disparities must sometimes widen to send correct signals to people to save more, work harder, change jobs, or get a better education. In the long run, poor people might enjoy higher absolute incomes in a society where income disparities are permitted to widen than one where law and social convention keep income differentials small. According to this argument, widening inequality is in the best long-term interest of the poor themselves.

For poor people in the United States, however, the theoretical advantages of greater inequality have proved elusive over the past two decades. Their absolute incomes have not improved; they have declined. Their absolute incomes do not exceed those of low-income residents in countries with less inequality; typically they are lower than those of people in a comparable position in other rich countries. The efficiency advantages, if any, of growing U.S. inequality have not been enjoyed by the poor, at least so far. They have flowed to people much further up the income scale.

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Why Has Inequality Increased?

Researchers on income inequality agree on two key facts. Greater family income inequality is closely connected to wider disparities in worker pay—disparities that in turn are associated with rising pay premiums for education, job experience, and occupational skills. In addition, shifts in family composition, specifically the continuing growth of single-parent families and the shrinking fraction of married-couple families, have reinforced the effects of widening wage inequality.

How much of the increase in family income inequality is attributable to rising wage disparities? Both male and female workers saw hourly pay disparities increase over the past two decades, though on average men saw their real earnings fall, while women got a raise. The hourly wage of workers at the 10th percentile fell 16 percent between 1979 and 1997. At the upper end of the pay ladder, wages at the 90th percentile rose 2 percent for men and 24 percent for women. Changes in annual earnings mirrored this pattern. Workers at the bottom of the pay scale saw their yearly labor incomes sink while workers at the top saw their annual pay increase. The gains were especially large among highly paid women.

One way to assess the impact of rising wage disparities on overall income inequality is to calculate how much overall inequality would have changed if wage disparities had remained unchanged. My calculation, using a standard statistical measure of income inequality known as the Gini coefficient, suggests that if male annual earnings disparities had remained unchanged between 1979 and 1996, personal income inequality would have increased about 72 percent of the actual jump. This means that the increase in men's earnings inequality explains about 28 percent of the overall increase in inequality. A similar calculation implies that despite the large increase in pay disparities among women, only about 5 percent of the increase in income inequality can be explained by growing earnings disparities among women. We can combine these two calculations to see what would have happened if

male and female earnings inequality had both remained constant after 1979. This third set of calculations suggests that two-thirds of the increase in personal income inequality would have occurred, even without a change in pay disparities. An implication of this finding is that just one-third of the



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increase in personal income inequality was due to the growth of male and female earnings disparities. Most of the growth was due to some other set of factors.

One factor was the changing American household. In 1979, 74 percent of adults and children lived in married-couple households. By 1996, this share had fallen to 65 percent. Inequality and the incidence of poverty are much lower in married-couple households than in single-adult households. If the percentage of Americans living in married-couple families had remained unchanged after 1979, about one-fifth of the 1979–96 jump in inequality would have been avoided.

Another trend has pushed up income disparities. Women who are married to high-income husbands are increasingly likely to hold year-round jobs and earn high incomes themselves. The increased correlation between husbands' and wives' earnings has widened the income gap between affluent dual-earner families and the rest of the population. If the husband-wife earnings correlation had remained unchanged, about one-eighth of the rise in overall inequality since 1979 would have been avoided. In other words, roughly 13 percent of the increase in income inequality can be traced to the growing correlation between husbands' and wives' earned income.

Policy Response

Though critics of U.S. social policy often overlook the fact, policymakers have not stood still in the face of momentous changes in the income distribution. The direction of policy has shifted noticeably since the early 1980s.

The shift began under President Reagan, who attempted to scale back and reorient welfare programs targeted on the working-age poor. His goal was to make the programs less attractive to potential applicants by cutting benefits or making benefits harder to get. One important policy change, later reversed, was to scale back payments to poor families with a working adult. Reagan thought welfare benefits should be focused on the *nonworking* poor. He expected working adults to support themselves.

The steep decline in hourly wages of low-skill workers made this view increasingly untenable. Measured in inflation-adjusted dollars, the minimum wage fell more than 30 percent over the 1980s, and wages paid to unskilled young men fell almost as fast. Few breadwinners can support families on wages of \$5 or \$6 an hour.

Congress and the president responded by reforming tax policy toward low-income families and broadening eligibility for publicly financed health benefits. The Tax Reform Act of 1986 removed millions of low-income Americans from the income tax rolls and boosted the tax rebates low-income workers receive under the Earned Income Tax Credit. The EITC was further liberalized in 1990 and 1993, greatly increasing the credits flowing to low-income breadwinners and their children. Spending on the credit increased elevenfold in the decade after 1986, reaching more than \$21 billion by 1996. The credit, payable to breadwinners even if they owe no federal income taxes, has raised the incomes of millions of families with extremely low earnings.

The EITC is the most distinctive American policy innovation on behalf of the working poor, and several European countries may eventually adopt a variant of it. While most cash assistance goes to people who do not work, the EITC goes only to low-income people who *do* work. In 1997 the credit provided as much as \$3,656 to a breadwinner with two or more dependents. For a parent working full time in a minimum-wage job, the EITC can increase net earnings nearly 40 percent.

The idea behind the credit is to encourage work by increasing the incomes available to low-wage breadwinners who have dependent children. Instead of shrinking as a recipient's earnings grow, the credit rises, at least up to a limit. At low earnings levels the credit increases by 34¢ or 40¢ for each extra dollar earned. Most labor economists who have examined the credit conclude that it has contributed to the sudden and sizable increase in job holding among unmarried mothers.

Congress has also liberalized the eligibility requirements for Medicaid health insurance to include a broad population of low-income children with working parents. Until the late 1980s, working-age families with children were usually eligible for health protection only if the families were collecting public assistance. Children typically lost their eligibility for free health insurance when the family breadwinner returned to work. The Medicaid liberalizations of the late 1980s and early 1990s meant that many children were enrolled in the program even if their parents had modest earnings and were not collecting public assistance.

Some state governments have established new programs to provide subsidized health insurance to members of working-poor families, including the adult breadwinners. Congress passed legislation in 1997 offering states generous federal subsidies to establish or enlarge health insurance programs for the working poor and near-poor.

As U.S. policy has expanded tax and health benefits for the working poor, state and federal policymakers have slashed cash assistance to the nonworking poor. General assistance, which provides cash aid to childless adults, has been scaled back or eliminated in several states. Aid to Families with Dependent Children was eliminated in 1996 and replaced with Temporary Assistance to Needy Families (TANF). The new federal program pressures all states to curtail cash benefits to poor parents who are capable of working. The head of each family on welfare is required to work within two years after assistance payments begin. Work-hour requirements are stringent, and states face increasingly harsh penalties for failing to meet them. The law stipulates that the great majority of families may receive benefits for no longer than five years and permits states to impose even shorter time limits. Over a dozen states have already done so.

The new welfare law—and the new state welfare policies that preceded it—helped produce an unprecedented drop in the nation's child welfare rolls. Since peaking in 1994, the number of families collecting public assistance for children has dropped more than 2 million, or 40 percent.

In sum, U.S. policy has become much less generous to the nonworking (but working-age) poor, while it has become much more generous to working-poor adults with children.

For many low-wage breadwinners with children, the recent policy changes—the increased generosity of the EITC, Medicaid, state-supported health plans, and child care subsidies—have offset the loss of potential earnings due to shrinking hourly wages.

The reforms are having other economic effects. Poor breadwinners with children have been induced to enter the work force—and stay there. Their entry contributes to the downward pressure on the wages of the least skilled. In effect, public subsidies to the working poor and cuts in welfare benefits to the nonworking poor have helped keep employers' costs low and thus helped fuel employers' creation of poorly paid jobs.

Future Directions

U.S. policies toward low-income, working-age families are not so callous that struggling families have been left wholly on their own to cope with declining wages. But they are not so generous that poor, working-age Americans have shared equally in the prosperity of the past two decades.

Different policies, such as those adopted in Western Europe, would have yielded different results. Some differences, including lower poverty rates and higher wages, make Western Europe a more pleasant place to live, especially for the poor. But others, including high unemployment, are unwelcome. It is not obvious that most Americans, even liberals, would prefer the European approach or approve the policies needed to achieve it.

While the current U.S. policy mix broadly reflects the preferences of U.S. voters, it is haphazard and fails to reach some of those who most need help. Two new policies could aid working-age people who have suffered the worst cuts in hourly pay. The first would assure some of the long-term unemployed a job at a modest wage. The second would make work subsidies more uniformly available and would provide them in a form that most voters approve.

Because public assistance to the nonworking but able-bodied poor is being drastically curtailed, it makes sense to assure at least some poor adults that they will be able to find jobs at a modest wage, however bad the local job market. In some cases this may involve creating publicly subsidized jobs that pay a little less than the minimum wage. It seems particularly important to extend this offer to parents who face the loss of cash public assistance. If voters and policymakers want unskilled parents to begin supporting themselves through

jobs, they should assure these parents that some jobs will be available, at least eventually, even when unemployment is high.

For poorly paid breadwinners, it is essential to improve the rewards from working. One possibility is to make a basic package of subsidized health insurance available to all children and young adults. Many Americans regard health insurance for children as a fair and acceptable way to help those in need.

Most health insurance for children is either publicly subsidized through Medicaid or privately provided through employer health plans. When insurance is financed by employers, most of the cost to employers shows up as lower money wages paid to workers. By publicly assuming some or all of the cost of paying for a basic health package for children, we could push employers to boost the wages they pay to insured workers who have child dependents. Such a move would have a greater impact on the pay of low-wage workers, for whom health insurance represents a big fraction of compensation, than on the pay of high-wage workers.

About 15 percent of all children (and nearly a quarter of poor children) have no health insurance. For these children and their working parents, publicly subsidized child health insurance would directly improve well-being and reduce out-of-pocket spending on medical care. It would also greatly increase the reward to work. Parents who do not work qualify for free medical insurance for themselves and for their children under Medicaid. Some lose this insurance when they accept a job that pays modest but above-poverty-level wages. A public health insurance package for *all* children would reduce or eliminate this penalty for accepting a job.

American economic progress over the past two decades has been quite uneven. Families and workers at the top of the economic ladder have enjoyed rising incomes. Families in the middle have made much smaller income gains. Workers at the bottom have suffered a sharp erosion in their relative income position. For some low-income workers, new public policies have helped offset the loss

of wages with larger earnings supplements and better health insurance. But many low-wage workers have not benefited from these policies. Humane public policy should try to assure that the most vulnerable Americans share at least modestly in the nation's prosperity. ■



**PUBLIC SUBSIDIES TO
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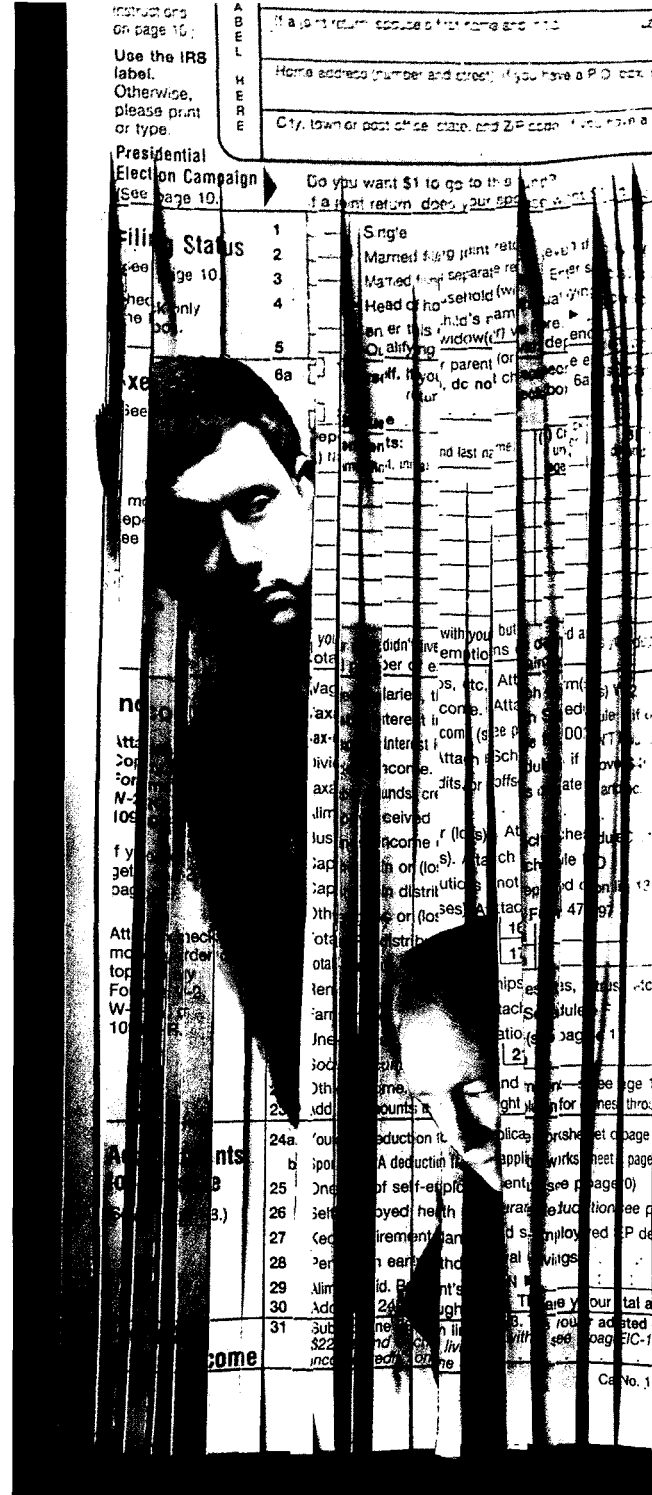
The time, money, and aggravation that tens of millions of Americans expend to understand and comply with the income tax is, it turns out, nothing new. In his 1776 *The Wealth of Nations*, Adam Smith noted that "subjecting the people to the frequent visits and the odious examination of the tax gatherers...may expose them to much unnecessary trouble, vexation, and oppression: and though vexation is not, strictly speaking, expence, it is certainly equivalent to expence at which every man would be willing to redeem himself from it." For Americans today, the "expence" includes maintaining records, learning the law, preparing the return or hiring a preparer, corresponding with the IRS, and learning how to reduce (or cheat on) taxes.

How Bad Is It?

For low-income households, headaches can arise from issues regarding filing status, abandoned spouses, dependency tests, the child and dependent care tax credit, and the earned income tax credit. For individuals with higher income, complexity arises in itemizing deductions, the treatment of capital income (particularly capital

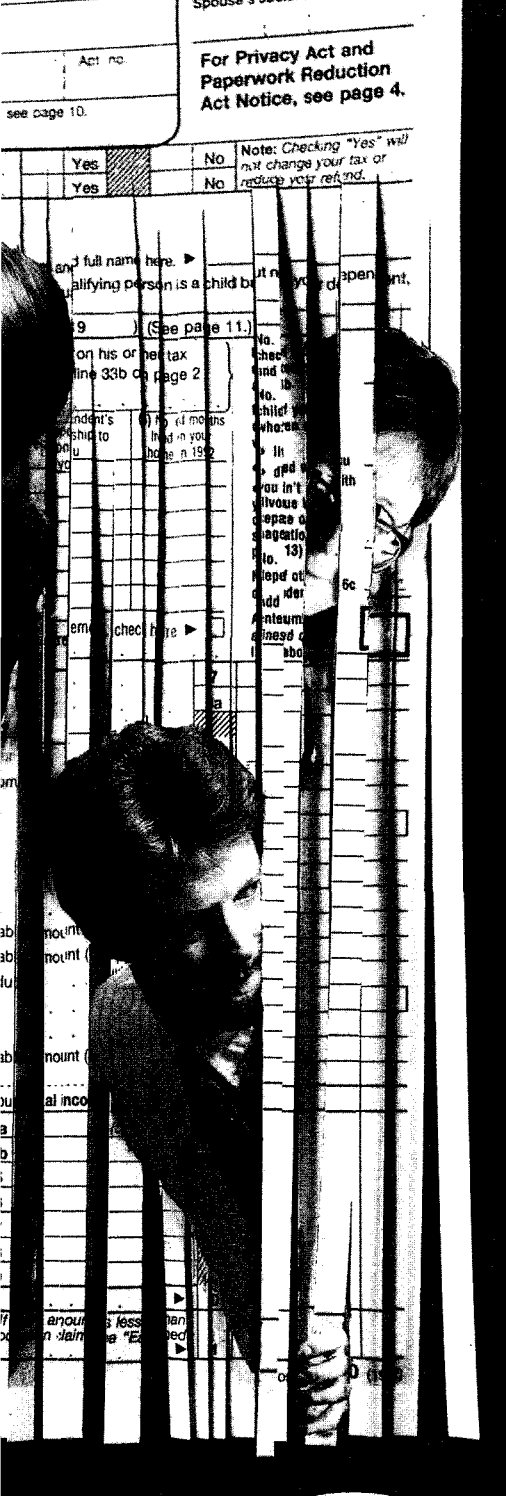
gains, interest deductions, and passive losses), and the alternative minimum tax. For small business owners, issues relating to inventory, depreciation, and distinguishing various expenses can be complicated. For large corporations, tax complexity is centered on depreciation, international income, the alternative minimum tax, and coordinating with state taxes. In

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WHY ARE TAXES SO COMPLICATED

AND WHAT CAN WE DO ABOUT IT



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addition, large firms are almost continually audited; one tax expert has described the basic corporate tax return as nothing more than an "opening bid."

Stories of income tax complexity are legion. The internal revenue code contains more than five million words. In *Money Magazine's* recent surveys, every one of 40 to 50 tax preparers came up with a different estimate of the tax liability due on a complex, hypothetical return. The share of taxpayers who pay tax professionals to complete their tax returns rose from 42 percent in 1981 to 51 percent in 1997.

Yet the costs can easily be overblown or distorted. For many people, the tax system is not that complicated. Almost 40 percent file simplified 1040A or 1040EZ forms, and about 18 percent file the 1040 but have no itemized deductions or business income. Many people go to preparers to expedite refunds or because they prefer to spend their time on other things rather than on preparing taxes. Marsha Blumenthal and Joel Slemrod found that while the average taxpayer spent 27.4 hours on filing income tax returns and related activities, 30 percent spent less than 5 hours, and another 15 percent spent between 5 and 10 hours. About 11 percent spent 50–100 hours, and 5 percent spent more than 100 hours. About half had no out-of-pocket expenses, and 17 percent paid less than \$50. Costs were highest among high-income and self-employed taxpayers.

Estimates of the total cost of complying with and running the individual and corporate income tax systems in 1995 go as high as \$600 billion, but the most reasonable estimates range between \$75 billion and \$150 billion, or about 10–20 percent of income tax revenue. Even at \$75 billion—or \$386 per adult per year—tax complexity imposes significant costs. Resources lost to compliance and administrative costs could be productively devoted to other activities. Complexity also generates confusion and aggravation among taxpayers, which can reduce confidence in the system. Thus, *other things equal*, social welfare would be improved by having a tax system that is simpler to comply with,

administer, and enforce. Of course, other things are never equal.

Tax Trade-offs

Since virtually everyone agrees that taxes should be easy to understand, administer, and enforce, why are taxes so complicated? The answer is that people also agree that taxes should be fair, should be conducive to economic prosperity, should raise sufficient revenue to finance government spending, and should respect individuals' privacy. Many people also think tax incentives should be used to pursue social or economic policies for the poor, housing, health, the environment, and small businesses.

Trading off these goals is difficult. Sometimes the meaning of a goal is unclear. Fairness, for example, is clearly "in the eyes of the beholder." Sometimes people differ about the best way to reach a goal. Is it best to help the poor via cash payments, tax incentives to work, direct provision of health care and education, or some other way? Finally, and most importantly, the goals are mutually inconsistent, and people disagree about which goals deserve the greatest weight.

As a result, tax policy involves trade-offs—and complexity is the result. In the end, complexity resembles pollution. Some of it is undoubtedly unnecessary, but much of it is the unfortunate byproduct of the production of goods that many people want.

For reasons of fairness, most tax systems tailor tax burdens to depend on individual characteristics. This creates complexity in several ways. It requires tracing income from the business sector to individuals. It requires reporting and documenting individual characteristics such as marital status, dependents, each person's level and composition of income and spending, and so on. And it requires tax rates that vary with individual characteristics, creating incentives to shift income to other people with lower income, such as children, or to other time periods when income might be lower.

Complexity also derives from using the tax system to house social programs that subsidize what Congress and a

significant portion of the population consider to be desired activities: housing, charity, health insurance, higher education, child care, state and local governments, retirement saving, entrepreneurial activity.

Closing tax loopholes also increases complexity. Any time a provision for special treatment or social engineering arises, it must be limited. If the child care credit, for example, is not intended to subsidize ski lessons in Aspen, some line has to be drawn concerning what is allowed and what is not. The taxation of financial income is particularly difficult in this regard.

Clamping down on tax evasion often increases complexity. Given the opportunity, people sometimes cheat on their taxes. Taxes on income from wages, for example, are withheld and sent to the government by the employer. The evasion rate is around 1 percent. Taxes on income from sole proprietorships are neither withheld nor sent in by a third party. The evasion rate here exceeds 30 percent. Many tax complexities exist to limit opportunities to cheat. In the late 1980s, a new law required people who claimed the child care credit to provide the Social Security number of the care provider. This both reduced the number of child care credit claims and raised by 65 percent the amount of income reported by child care providers.

While trade-offs among consensus policy goals are an important source of complexity, political factors are another. That is, complexity can also be the result of the production of goods that only a few of us want. Politicians and interest groups have a vested interest in certain types of subsidies that reduce taxes on favored constituencies. The lavish campaign contributions received by members of the House Ways and Means Committee do not come from lobbyists deeply respectful of a tax code clean of special subsidies. There is no lobby for simplicity.

Sometimes the tax code is used to hide subsidies that would not be supported as outright spending. Consider a "homeowner welfare program" in which taxpayers earned an entitlement to help pay their mortgages. The entitlement grew in proportion to mortgage size, interest rate, and tax rate, but anyone whose entitlement was less than \$6,000 received nothing from the program. Obviously, not a very appealing idea, but not that different from the mortgage interest deduction.

And let's face it: taxpayers *like* complexity that reduces their taxes. It's just complexity that raises taxes that annoys. Thus, people will grump about the new filing requirements for capital gains or child credits, but few will volunteer to give up those cuts.

The real question is not the total amount of compliance costs, but whether society gets good value for income tax

complexity. My view is that, generally, we do not. The economy-wide perspective is important here.

Suppose people had to fill out ten extra lines of the tax form to receive a \$1,000 tax cut. Each might regard that as "good complexity," well worth the added cost of providing a few extra pieces of information. But in the aggregate, the revenues would have to be raised from taxpayers, so everyone's tax "cut" would be from a higher initial tax liability and net taxes would be the same. Thus, from a social perspective, the sum of all individuals' "good complexity" would be zero or negative.

Many existing provisions designed to encourage certain activities end up either largely subsidizing activity that would have occurred anyway or creating new problems. Many of the reasons for complexity are completely inappropriate: hiding unpopular programs, special loopholes that fuel campaign contributions. It is hard to see any impact on economic growth, and the "fairness" that occurs is a very strange kind. The subsidies help one group, but at the expense of all others.

Fundamental Tax Reform and Simplicity

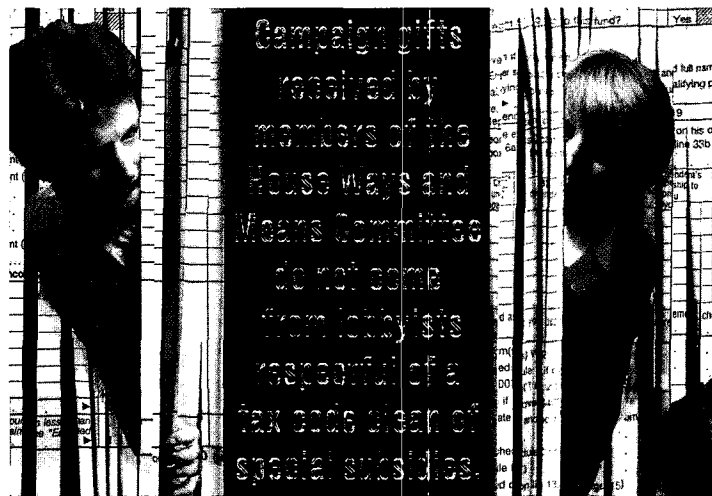
The complexity of existing taxes is a powerful force behind the movement to

replace the income tax with a flat tax or sales tax. The new systems would shift the tax base to consumption, rather than income, flatten tax rates, eliminate all deductions and credits, and collect most or all taxes at the business level. Plan advocates promise great simplification, and it is clear that pure versions of either plan would be much simpler than the existing system. But, well, it's not that simple.

Just as the income tax has deviated from a low-rate tax, with a one-page form and three pages of instructions, the flat tax or sales tax would also be under pressure to depart from its pure form. The thousands of lobbyists now working in Washington are unlikely to pack up and go home. In short, you can repeal the tax code, but you can't repeal politics.

On paper, for example, the sales tax would be vastly simpler than the current system. But the 45 existing state sales taxes are nothing like the single-rate, no-exemption sales tax that is proposed at the national level. The states feature numerous exemptions for goods and especially services, as well as different rates for different goods.

Moreover, as Joel Slemrod has shown, it is inappropriate to analyze simplicity independently of evasion and enforcement. The sales tax rate required to replace federal taxes would be well above the 23 percent rate claimed by advocates. After correcting for mistakes in the way the proposal treats government spending, and adjusting for political factors that would erode the tax base and for a reasonable amount of tax avoidance



activity, a federal sales tax could result in mark-ups at the cash register in excess of 70 percent. At these rates, the incentive to evade sales taxes (which, unlike the income tax, feature no third-party withholding to aid in compliance) and the political pressure to exempt certain goods from taxes would be strong.

No country has ever successfully run a high-rate national retail sales tax. Many have tried to implement some variant of a sales tax and have given up. European governments, and numerous conservative and liberal scholars, have concluded that sales taxes at the required rates would be unworkable.

How about the flat tax? Under such a tax, businesses pay taxes on gross sales minus the cost of materials, services, capital goods, wages, and pension contributions. Individuals pay taxes on wages and pensions, less personal exemptions. No other income is taxed, and no other deductions are allowed. Flat tax advocates claim that individual and business returns will fit on a post card. In theory, the flat tax promises to be as simple as the sales tax.

But flat tax proponents have already acknowledged the need to provide transition relief to businesses that bought assets under the old system. Various flat tax plans include deductions for mortgage interest, charity, and payroll taxes. Deductions for health insurance and state and local taxes, the earned income credit, and graduated tax rates on wage income cannot be far behind. Allowing for these items would raise the required flat tax rate to about 32 percent and complicate taxes.

More fundamentally, the flat tax makes different distinctions than the existing system does. This will create new “pressure points,” and so could create a host of new compliance and sheltering issues and accentuate problems created by existing regulations. For example, the differential treatment of “interest income” and “sales” under the flat tax has led tax experts Charles McLure and George Zodrow to conclude that the business tax “contains unacceptable opportunities for abuse.” As attorney Alan Feld notes, the flat tax will either generate complicated business transactions (to skirt the simple rules) or complicated tax laws (to reduce the gaming possibilities), or both.

The flat tax would cause huge changes in tax liabilities for businesses across the country. It would create situations where some businesses with large economic profits would pay no taxes and others with economic losses would face steep taxes. Amending the tax to address these issues would create complexity.

At the individual level, the flat tax would renegotiate every alimony agreement in the country. Under the flat tax, alimony payments would no longer be deductible and receipts would no longer be taxable. Another difficulty would arise from earnings that are subsequently stolen. Under the flat tax, a robbery victim is still liable for taxes—and the robber is not. Under the income tax, it is the other way around. Additional anomalies will no doubt be discovered. Each of these problems with the individual tax could be fixed—but each solution would require a bigger postcard. Even a flat tax modified along

these lines would be simpler than the current system. But with a rate of 30 percent or more, a realistic flat tax may not be politically appealing.

Simplifying the Income Tax

What about tax simplification options in the existing system? To begin with, procedural changes could raise the visibility and explicit consideration of simplicity and enforcement issues in the making of tax policy. For example, the recent IRS restructuring legislation requires the IRS to report to Congress each year regarding sources of complexity in the administration of federal taxes. The Joint Committee on Taxation is required to prepare complexity analysis of new tax legislation that affects individuals or small businesses.

It is also possible to eliminate the need for certain taxpayers to file tax returns. Thirty-six countries already use a return-free system for some of their taxpayers, replacing end-of-year filing requirements with withholding throughout the year and end-of-year reconciliation by the tax agency. In recent work, Janet Holtzblatt of the Treasury Department and I found that 52 million U.S. taxpayers could be placed on a return-free system with minor changes in the structure of taxes. These families have income only from wages, pensions, Social Security, interest, dividends, and unemployment compensation; they do not itemize deductions; and they face at most a 15 percent tax rate. Although the net compliance and administrative savings may not be great (because these people already have simple returns), a return-free system could reduce the psychic costs (fear and aggravation) associated with tax filing for the affected taxpayers.

Structural reforms could also reduce complexity. Broadening the tax base by eliminating deductions and preferences and taxing capital gains as ordinary income directly removes complexity. Increased standard deductions remove many people from the tax system. Lower tax rates would reduce the value of sheltering and cheating. Increasing the number of people who face the same “basic” rate facilitates the withholding of taxes on interest and dividends at the source, further simplifying taxes and increasing compliance. In short, broadening the base and reducing the rates can be revenue-neutral, fair, and efficient, as well as simplifying. Such reforms make taxes simpler for many taxpayers and could reduce compliance costs by 10–15 percent.

Getting Serious about Simplicity

We could have much simpler taxes if we were willing to change our preferences and forgo common notions of fairness, reduce our concern with tax evasion and loopholes, eliminate a raft of targeted social and economic incentives, and reduce the extent to which taxes depend on individual characteristics. Retaining those preferences, however, does not condemn us to much of the seemingly needless complexity of the current code. While the goal of fundamental tax reform is both more distant and less likely to resolve current problems than its advocates might care to admit, the existing system could be improved and simplified with a concerted effort to take simplicity seriously as a distinct policy goal. ■



THE AUTOMOBILE is the solution to most Americans' transportation needs. But its very success has generated serious problems—most notably, congestion, pollution, and energy inefficiency—that need to be addressed by public policy.

Transportation policy discussions feature many vocal “enemies” of the automobile who believe that the remedy for every car-related problem is less automobility. They want to “get people out of their cars.” Their aim is to reduce auto travel by making it more expensive and less convenient. They want people to take public transit, to bicycle, to walk, and to eschew the suburbs. But as policymakers seek solutions to the problems generated by mass auto use, they must acknowledge the enormous benefits Americans derive from the convenience, mobility, and privacy of their cars. Crafting practical and politically effective remedies to the auto's problems begins by recognizing the indispensability of automobility.

FEWER TRIPS OR BETTER CARS? Automobility

BY JAMES A. DUNN, JR.

Fuel Efficiency and Emissions

One of the most promising paths for policymakers to pursue in tackling the problems of the automobile is technology. As Daniel Sperling, a transportation energy use analyst, has noted: "Given . . . the huge promise of new technologies, the focus of any effort to create a more environmentally benign transportation system should be technical innovation." In fact, the United States has been the world leader in "technology-forcing" automobile regulations. The federal government adopted exhaust emissions standards nearly 20 years before most European countries, and American standards are still stricter than those of any European country. The same is true for fuel efficiency standards.

Will resuming progress toward enhanced fuel efficiency and lower emissions rekindle adversarialism between the government and the auto industry? Left to its own devices, Detroit will prefer to indulge consumer preferences for large, powerful cars rather than undertake the risk and expense of introducing fuel-efficient new vehicles. Thus Detroit cannot be simply left alone. But both politicians and auto executives have learned something from the past 30 years. Detroit does not want to cause a second coming of Ralph Nader. Nor is Congress the fertile ground for politi-

cal entrepreneurialism on automobile issues it once was.

The automakers strongly oppose further increases in the corporate average fuel economy (CAFE) standards. A hike, they note, would raise production costs, increase the price of their cars to consumers, and lower total sales, especially sales of their profitable sport utility vehicles and large luxury vehicles. They also oppose state-level requirements to manufacture and sell significant numbers of electric vehicles, arguing that "If electric vehicles are desirable and can be marketed and sold at a fair price . . . mandates are not needed. . . . If electric vehicles are not marketable, mandates could create distorted markets with severe adverse unintended consequences." Automakers fear such mandates would result in having to sell subsidized electrics far below their cost, driving up the cost of gasoline-powered cars and lowering total revenues and profits.

But politically astute leaders of the auto industry today realize that, in the

face of an upsurge of public concern over greenhouse gases and global warming, they cannot stand pat and refuse to cooperate. The technology for improving fuel efficiency and reducing emissions is available, and Detroit's executives are aware that the government knows it. In return for less punitive and more flexible regulations, they would be willing to offer some cooperation. Indeed, in 1998 automakers publicly promised to produce "superclean" cars (low-emission vehicles) in return for assurances that other states would not follow California's lead and demand zero-emission vehicles.

Likewise, Congress has learned that dealing with Detroit requires both carrots and sticks. If the stick is higher federal fuel-economy standards, the carrot must be flexibility in meeting the standards and perhaps a chance to participate in designing the new regulations.

How high could the new negotiated standards be? Increases in CAFE standards up to 36 miles per gallon for passenger cars and 27.5 miles per gallon for light trucks would be cost effective under most fuel price assumptions. But automakers would likely be willing to go that far only if they are permitted to continue marketing their profitable lines of sport utility vehicles and minivans while making steady progress toward

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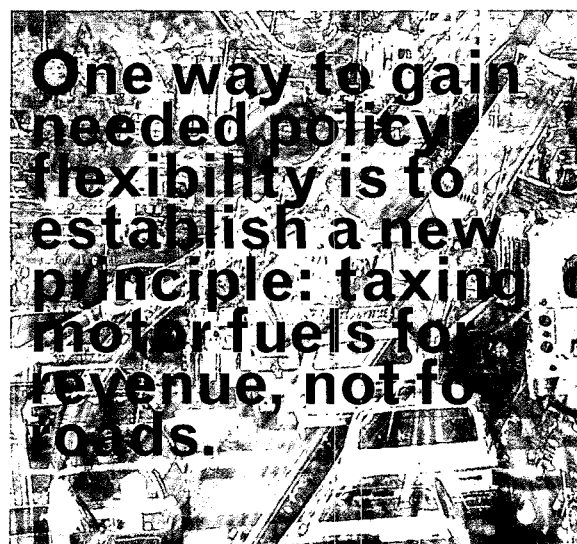
improved overall fuel efficiency.

One simple strategy would be to give auto manufacturers “carry-over” credits: if they exceeded the standards in their automobile fleet, they could use the credits on their light truck fleet. A more complex possibility might be “carryover” between emissions standards and fuel economy. Perhaps companies that received credits for meeting a zero-emissions vehicle (ZEV) quota could use them to offset fuel economy shortfalls in their conventional car or light truck fleets. For example, for every ZEV unit sold, an automaker could count the sale of a 17.5 miles per gallon sport utility vehicle as if it were a 27.5 miles per gallon vehicle. Or a trading system could be instituted whereby a small new company that manufactures electric ZEVs would receive a transferable credit that it could then sell to a full-line manufacturer to be counted toward the large company’s ZEV quota. GM might find it initially cheaper to buy such credits than to incur the cost of building electric cars. And small electric vehicle makers would be encouraged by the extra source of income that the scheme offered them. Later General Motors could simply buy a successful electric vehicle manufacturing company and use its established sales to meet its own quota.

Many more possibilities for innovative combinations of incentives and regulations exist. But the key is to rely on broad performance criteria that can be met by a range of technologies involving different propulsion systems. Designing specifications only for battery-powered electric vehicles, for example, might inhibit the development of hybrid-electric or hydrogen-fueled vehicles. Broad criteria will allow as much room as possible for market forces and consumer preferences to operate and avoid the pitfall of prematurely picking a technology that turns out to be less valuable than originally thought.

Taxes and the Highway Trust Fund

Detroit has always said it prefers higher gasoline taxes to higher CAFE standards



as a strategy to reduce automotive energy consumption. One industry-sponsored study concluded that higher gas taxes could reduce petroleum consumption just as well as new CAFE standards—and at 40 percent less cost. Paul McCarthy, a research economist at Ford Motor Company in the mid-1990s, called higher fuel taxes “the great underexplored conservation policy in the United States.”

Some may regard Detroit’s support of gas tax hikes as a cynical public relations gimmick—the political chances of major increases are, after all, exceedingly slim. But why not take the industry at its word and give it an incentive to work for gas tax increases? Why not explicitly link progress up the ladder toward higher CAFE standards to progress on increasing motor fuel taxes? Former Transportation Secretary Elizabeth Dole set just such a precedent in airbag regulations in the mid-1980s. If two-thirds of the states adopted mandatory seat belt laws, auto manufacturers would not have to install airbags. With that incentive, Detroit lobbied hard for seat belt laws in state legislatures across the country.

A promise to postpone a scheduled increase in CAFE standards if gas taxes rise to a certain level would encourage car manufacturers to “put their money where their mouth is.” They could lobby federal and state legislatures in support of gas tax increases that have the equivalent effect of the scheduled hike in CAFE. If the gas taxes go up, the standards do not.

Once the gas tax is increased, the next crucial question is whether to pour the resulting revenues into the highway trust fund. The trust fund regime, wonderfully useful in building highways in the interstate era, has become a political and administrative strait-jacket.

The best way to gain needed policy flexibility is to establish a new principle: taxing motor fuels for revenue, not for roads. Making gasoline taxes into an accepted source of general government revenues will gradually result in the automobile paying more of its true costs. Pressures for adequate general revenues succeeded, temporarily, in producing the modest hikes of 2.5 cents and 4.3 cents per gallon in the Bush budget deal and the Clinton program of 1993. Those revenues were subsequently restored to the trust fund, but the precedent for “diversion” has been set.

Establishing the principle of motor fuel taxation for general revenue will probably require political compromises with the still powerful interests benefiting from the trust fund regime. It will also probably be necessary to “grandfather” or guarantee the existing level of appropriations to highway and transit programs to reassure their stakeholders that they will not face abrupt declines in federal support.

In the long run, the question may be settled by technology. Technical advances may put an end to the era of funding highway programs through dedicated taxation of motor fuels. As internal combustion engine cars become more efficient under pressure from new propulsion technologies such as the electric, hybrid-electric, and fuel-cell-powered vehicles, gasoline consumption will level off and begin to decline, and so will gas tax revenues. To maintain highway funding, taxes on the shrinking base of petroleum fuels will have to escalate sharply, or new revenue streams will have to be brought on line, perhaps opening the door to road-use charges by means of electronic fare collection. It is conceivable, indeed likely, that before the middle of the new century the issue of dedicat-

ing gasoline taxes to highway trust funds will have been superseded by the issue of electronic road-use charges. What kinds of road-use fees should be imposed? Who should collect them? How should they be spent?

Public Transportation and Automobility

Despite more than \$140 billion in federal, state, and local subsidies since 1964, public transit continues to lose market share to the automobile. Although supporters of public transit contend that it could make a comeback if only more public subsidies were provided, in fact public policy cannot recreate the past. As long as people are free enough and wealthy enough to own automobiles, no amount of public investment in transit can reverse mass transit's decline. Even if new rail transit investments attract some additional riders to the transit system, revenue from the new riders will almost certainly not be enough to pay for the system's operating cost (not to mention the capital costs), and it will probably not even be enough to increase transit's modal split of passenger miles vis-à-vis the automobile.

In May 1997 transit industry leaders and transportation professionals met for three days under the auspices of the Transit Cooperative Research Program to "search for new paradigms" for public transportation. Their report, *Reinventing Public Transportation*, called for the transit industry "to break out of its entrenched practices...to consider bold, new services and innovations." The report recommended that transit agencies become "mobility managers," overseeing customer-friendly delivery of transportation services, including jitneys and car pools, which could be operated by public organizations, private contractors, cooperatives, or voluntary organizations. The report concluded that transit must draw on advanced information technologies to become "at least as smart, if not smarter, than its chief competitor, the private car."

That recommendation ultimately points toward a solution to the transportation problems of poor Americans isolated in urban ghettos and cut off



from suburban economic opportunities. Many of the urban poor cannot afford to own cars, and existing transit service connects them to the new jobs in the "edge cities" poorly if at all.

As a practical matter, the solution to the problems of the carless poor is not to build expensive new rail systems from the ghetto to the urban fringe, but to make automobile-based mobility alternatives more widely available and to provide "mobility subsidies" for the truly needy.

The most automobile-like public transit mode, taxicabs, already carries more passengers than all other kinds of public transit in the nation put together. Taxis provide service that is superior to regular public transit for most destinations for the elderly, the handicapped, business persons, and tourists. The main drawback of taxis for poor people is cost—the fare averages about five times higher per mile than transit. Transportation economists have argued that existing regulations limit competition in the taxi industry enough to peg fares at artificially high levels. Restrictions on entry into the taxi business have given rise to a black market in so-called "gypsy" cab service. Illegal taxis often flourish in low-income black neighborhoods that legal cab companies serve poorly or not at all.

Deregulating taxi service and permitting more private jitneys, paratransit vans, and express shuttle buses to compete in the market for urban transit services could significantly increase transportation services available in low-income neighborhoods. If deregulation were accompanied by user-side mobility vouchers provided by social service agencies, it would give the carless access to a level of urban mobility that is closer to automobile quality than to conventional transit. Targeting public subsidies directly to those who most need them avoids the problem of subsidizing rail service for high-income commuters. It would cost the public treasury much less than attempting to run conventional rail or bus transit to the myriad dispersed

destinations in today's vast urban areas.

Preserving Automobility, Improving Automobiles

Federal efforts to promote innovations in the management of roads and highways, rail lines and buses, should rely less on new national spending programs and new regulations laid down in Washington. The money (what little there is) gets spread too thinly across this vast continent, and the regulations impede local innovation and experimentation. A more useful federal role would be to offer incentives for innovations in the context of a genuine policy experiment. Washington should provide matching funds and seed money for limited local initiatives in congestion pricing and deregulation of transit and paratransit. The intent of the legislation would be true demonstration programs, not pork barrel projects. The federal government also should ensure that these jointly funded experiments are carefully and independently evaluated. Then the information on notable successes can be widely disseminated to states and communities to be implemented, adapted, or rejected according to their own needs. It is cheaper to experiment and evaluate than to fund nationwide programs or to mandate that local governments and private businesses fund programs.

Though there are those who would solve the problems of automobility by dramatically reducing auto usage, the most effective policy responses to pressing auto-related problems do not attempt to discourage people from using their cars. Rather, they encourage improvement in the technology of the auto itself. The American people do not want restrictions on their ability to use their cars. They want the kinds of new automobiles that will meet their personal need for mobility and their collective need for a cleaner environment. From the creation of the jeep in World War II to the airbag-equipped, CAFE-conforming fleet of passenger cars today, the U.S. auto industry has proved that it can meet its customers' and its country's needs. ■

ABOUT

BY CLIFFORD G. GADD
AND BARRY W. ICKES

RUSSIA

No Time for Illusions

The collapse last August of Russian financial markets and the dismissal of the Kiriyenko government is seen in Russia as the end of an era. Radical market reform is over. In its place is emerging a new “Moscow consensus.” Now, adherents say, it is time to try a new course of government-directed industrial policy, including protecting domestic producers against foreign competition, and looser monetary policy.

According to the new consensus, not only did seven years of radical market reform fail to put Russia on the path to becoming a modern economy, it impoverished the country and left it defenseless. This harsh view is carried to extremes by radical elements who attribute Russia's troubles to a conspiracy by adversaries in the West, abetted by certain circles at home. Just as German nationalists in the early 1920s helped propagate the idea that Germany lost World War I because a small group of traitorous politicians sold out the nation, Russian nationalists today are blaming a small group of pro-market reformers for adopting an economic program that destroyed a strong industrial and military power. In Russia today, as in Weimar Germany, the treachery is being attributed to the Jews.

Western reaction to the new consensus has been to disengage. Some think that maybe Russia does need a brief retreat from reform—which can perhaps resume later under calmer conditions. Others are simply at a loss: what to do when nearly every individual and every policy that the West supported is now out of favor? Some hope the new policies lead to disaster—and thus galvanize Russians into serious reform.

We disagree. Now is not the time for illusions, self-delusion, or scapegoats. Now is the time to face the truth and tell the truth. The Russian economy is indeed in sorry shape. Many hopes have been dashed. But reformers did not force this fate on Russia. Russia never acceded to reform. Indeed, in its struggle to avoid reform, it created what we call “the virtual economy.”

The existence of the virtual economy now makes it harder than ever to reform successfully. The difficulties will only increase as time passes. But the disastrous state of the economy is not an argument for disengagement; on the contrary, it dictates a more pro-active attitude from the West.

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RUSSIA

Now is the time to face the truth and tell the truth. The Russian economy is indeed in sorry shape. Many hopes have been dashed. But reformers did not force this fate on Russia. Russia never acceded to reform. Indeed, in its struggle to avoid reform, it created what we call “the virtual economy.”

What Really Happened

Russia was always more hesitant about market reform than the countries of Eastern Europe. For the Poles, for example, the alternatives at the beginning of transition were: “Reform and be part of Europe” or “Don't reform and be subject to Russia.” No matter how painful the transition, few Poles would have opted for the latter. The incentives to make reform work were huge. Whatever backsliding might occur, whatever mistakes might be made, pressure to push ahead was continuous.

Few Russians saw market reform as a life-or-death matter. Many were opposed from the beginning. Most others were willing to accept some elements of a free market, particularly those that offered personal economic freedom. A passionate few adherents of the market economy excepted, most policymakers saw market reform as a way of correcting the old system, rather than a thorough rejection of it. They would reform to raise consumption standards and become competitive in the global economy. They would be greatly helped by the opportunity to shed the burden of massive military expenditures.

Russians quickly took advantage of reform's benefits—the expanded choice of goods, the new opportunities to choose jobs and careers. But they equally quickly began taking those opportunities for granted. Very early on, most Russians began to feel that further reforms meant, on balance, more pain.

Russia's less-than-wholehearted commitment to change was compounded by great objective difficulties. Eastern Europe's economy had not been nearly as distorted as Russia's by commu-

nism and hypermilitarization. Russia had been subject to central planning much longer than the Eastern European satellites. The foundations of its industry were laid under communism. Private agriculture was wiped out.

Thus if Russians were to be anywhere near as persistent as, say, the Poles in pursuing market reform, they would need huge incentives. The West did not provide those incentives. Instead, it provided just enough financial assistance to allow Russia to avoid making hard decisions—just enough

aid to sustain the old system. Certainly the West did not impose real conditions on the use of the funds it did provide—if indeed conditionalities can be imposed on a nuclear superpower.

Neither the carrot nor the stick was big enough. Implicitly acknowledging that fact, the Western governments backed off and handed the International Monetary Fund the impossible task of pushing a nation that did not want to reform while being prevented from pushing hard.

The Russians quickly learned that the threat of failure was the most reliable way to get aid. Inside Russia, enterprise directors had been practicing that approach on a micro level. The best way to get a bailout was to credibly threaten dire social and political consequences if you didn't get it.

With no perceived incentive to change, the Russians simply tried to get all the handouts they could without any idea of what to do with the money. The absence of a vision of what to do to make Russia a modern and competitive economy was not regarded as a serious problem by liberal reformers. People are not required, or even supposed, to know where they are going in a full-fledged market economy. The proper macro-economic policies would ensure “hard budget constraints,” which by definition would enforce the correct behavioral changes, like it or not.

But this did not happen in Russia. The radical reform measures introduced by the Gaidar government in late 1991 and early 1992 were initially a shock, but they were soon buffered and absorbed with relatively little impact. To the extent that behavior changed, it was more to seek protection from the market than to embrace it. The set of peculiar mechanisms that provided that protection is what we have termed Russia's virtual economy.

The Virtual Economy

The virtual economy is the result of efforts of enterprises and households to survive when the market value of the things they produce is smaller than the value of what is needed to produce them. In the virtual economy, enterprises make pretty much the same products they made under the Soviet system and in pretty much the same way. The enterprises can continue to produce these goods because they have a guaranteed set of “buyers” (to use the term loosely) and because they avoid the use of money. Avoiding money, through barter and other forms of nonmonetary exchange, allows the goods to be overpriced, giving the appearance of more value being produced than is the case.

These overpriced goods are then delivered to the government in lieu of taxes, or to value-adders, mainly energy suppliers such as the natural gas monopoly *Gazprom*, in lieu of payment, becoming the means for continued subsidization of unprofitable, even value-destroying, production in the Russian economy. As much as 70 percent of transactions among industrial enterprises involve no money. Similarly, offsets, barter, and the like account for 80–90 percent of tax payments by these major industrial enterprises.



The Privatization Program

An important force behind the emergence of the virtual economy was the nature of the Russian privatization program, which was essentially a giveaway to insiders—that is, the directors and workers. The country's manufacturing dinosaurs, the enterprises that needed to change the most, were captured by those who had plenty to lose if they were restructured. Meanwhile, government shares in valuable enterprises went to the large banks and other political insiders.

Privatization was supposed to have—and alone would have—spelled doom for weak manufacturing enterprises. But the enterprises continued to be subsidized, though not directly by the government, but by *Gazprom*. To better understand that, it is worthwhile considering *Gazprom's* place in both the Soviet and the Russian economy.

The Soviet economy was characterized by value creation in the resource sector and value destruction in manufacturing. But because the preferences of the leadership were biased toward defense and heavy industry, it was important for these sectors to appear to be producing value, and the price system was adjusted accordingly. (Because all property was state owned, the returns to specific assets were irrelevant.)

Privatization in Russia involved demarcating assets into specific bundles and assigning ownership to them. But because individuals could have little idea of the market value of their assets, human or physical, in the vastly different economy of market reform, privatization was tantamount to giving every Russian a lottery ticket. In the lottery, to simplify a bit, *Gazprom* was the winning ticket. *Gazprom* shareholders received valuable assets, while everyone else ended up with assets with no market value.

The virtual economy is the Russian democracy's way of making the winner-take-all privatization lottery more equitable. Redistributing *Gazprom's* value gives other tickets value. Essentially, *Gazprom* must pay off other parts of society in a bargain to retain its share of the value that is produced. But because the winner-take-all distribution reflects the market value of the assets, redistributing value in the virtual economy postpones reform.

Reform: Harder Than Ever

As early as 1994, the virtual economy had become consolidated, and the possibility of reform was becoming ever more remote. The Russians had to be arm-twisted into nearly every single positive change they made at the central policy level. Meanwhile, at the micro level, enterprises, households, and local governments continued to develop and to perfect ways to protect themselves from the market.

By now, reform has become nearly impossible. Kiriyenko's tenure made that clear. While there will undoubtedly be renewed attempts at reform, they are almost sure to fail. Each time, the task will become more difficult.

In the first place, the system that needs reform is not the same as it was in 1991–92. The virtual economy has evolved and adapted over time. It has not been imposed from above. It

grew from the bottom up and is therefore very robust. The key elements of the virtual economy that have been carried forward from the Soviet economy could not be dismantled by the conventional methods of macroeconomic stabilization and nominal privatization. The Russians want this system; it protects people, and they will protect it.

And even if enterprises were willing to change and adapt and become competitive in the market, the technical challenge is greater today than it was six or seven years ago. Investment has fallen to next to nothing. In the productive sectors of the Russia economy, in 1997 investment was only 17 percent of 1990 levels. In the core areas of machine building, engineering, and metal-working industries, it was 5.3 percent of 1990 levels. Russia's economy needs massive modernization. It has not had it. A physical plant that was old and noncompetitive to begin with is now even older and less competitive. Even by official Soviet standards, more than one-third of the equipment in Russian industry was physically obsolete when reform began in 1992. It was quite literally junk. In 1996 the share of junk reached 50 percent. It will be 60 percent in 2000.

Russian enterprises have also lost human capital. Workers in the weak industries who felt they had a chance in the new market economy have left. Those who remain behind are the least productive.

Finally, Russia is in a permanent debt trap. Debt builds up, not down—and not just financial debt. At every step along the path to the market, reform will be encumbered by society's cumulative nonpecuniary, unpaid costs, especially damage to the environment and the undermining of public health. These costs, unlike the financial debt, have to be paid some time, somehow. They cannot be erased by a default.

Dangerous Consequences

The continued existence of the virtual economy has implications for Russia's economy in four areas: economic growth, the national integrity of the economy, development of the private sector, and the ability of the public sector to fulfill its tasks.

In the short term, the virtual economy appears to grow while it actually contracts, thus fatally compromising the future competitiveness of the economy. For the short term and

middle term, the system is likely to remain stable. But at each stage of the journey, the economy will be less competitive than it began. Where will it end?

The virtual economy has a natural tendency to fragment a national economy into smaller, self-contained local economies. Local government budgets are already more "virtualized"—demonetized—than even the federal budget. Local governments protect the local market for the benefit of their local virtual economy. In the current crisis, regional and local governments have intensified the tendency toward localism by introducing measures to hoard goods locally and ban exports, especially food, to other regions.

The virtual economy will not eliminate the private sector; indeed, it needs a private sector as a source of a minimal amount of cash. But the dominance of the virtual economy is incompatible with a genuinely independent, prosperous private sector. Small businesses will be permitted to exist, but they will be hobbled in the market, neither allowed to supply to public-sector customers or to develop as subcontractors. More seriously, because they generate cash, they will be subject to a heavy tax burden.

The virtual economy will continue to shrink and impoverish—and demonetize—the public sector. The federal government budget is key. The federal government remains woefully short of cash, real money, to meet its obligations. In 1997, with the world mesmerized by its booming stock market, Russia collected less than 60 percent of its taxes in monetary form. Its cash tax revenues came to barely \$23 billion at 1997 exchange rates. Even counting other sources of monetary revenues—privatization sales, customs duties—the government was able to raise no more than about \$40 billion, not

counting borrowing at home and abroad.

With the highly publicized tax collection campaign last winter, the government raised slightly more cash. But as the virtual economy model predicts, the extra cash to the budget came at the expense of the rest of the economy—and helped precipitate the default on August 17. Kiriyenko concluded truthfully: "We can't pay both the bankers and the people. I choose the people." He defaulted on \$40 billion of short-term treasury bills, known as GKO's—the equivalent of the entire cash receipts of the federal government for 1997.

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Since the default, tax collection has been disastrously low. Even if the new Primakov government is able somehow to collect as much cash in real ruble terms in 1999 as in 1997, the devaluation of the ruble against the dollar puts the government in much worse straits for repaying foreign debt. The dollar value of the government revenues would likely be less than \$20 billion, and the foreign debt repayment obligation facing the Russian federal government in 1999 is \$17 billion. Inevitably the payments will have to be postponed.

What Can Be Done?

The temptation to disengage from Russia in these circumstances is seductive. But one need only consider the long-term consequences of allowing further deterioration to realize that something must be done. The question is what? We have no magic bullet, but we do believe that the concept of the virtual economy suggests the general outlines of a policy to save Russia. Completion of the task will take decades, not years. But it must begin now.

It is crucial to address all three root causes of Russia's economic problems: destruction of value within the system, "leakage" of value out of the system through corruption and looting, and, as a consequence, the need to infuse value from the outside—that is, through borrowing.

A four-step strategy would target those root causes. The first step is to abandon all pretenses. Russian leaders must lay bare the reality of the economy—now. They no longer have reason to fear that "telling the truth will only make things worse."

Policymakers must not only stop concealing the fact of value destruction, they should try to quantify it. By all means, they should also speak openly about the benefits—social and political stability—of continuing the value-destroying enterprises. But admit the costs. Then people can decide.

In the same spirit, leaders should be more realistic about the potential of the Russian economy. It is much lower than has been acknowledged, which makes it clear that the cost of sustaining the value-subtractors is high in the long run.

The second step is to reduce the value destruction—not suddenly and comprehensively, but systematically. The mechanics are simple: enforce bankruptcy of genuinely non-viable enterprises. But the political will is the key issue. Step

one—disclosing the costs of maintaining the virtual economy—is a precondition to gaining support for a reasonable program to reduce value destruction.

The third step is to eliminate leakage. Stop the sweetheart deals. Tighten government; reduce waste. Improve the tax code. Perhaps go as far as nationalizing *Gazprom*. Impose exchange controls. Some of these reforms are already demanded by the IMF. Others may challenge the standard recommendations.

Finally, write off the debt. To give the country the breathing space to make the first three steps meaningful, Russia's more

than \$70 billion of post-Soviet era debt must be radically restructured. The model will be the agreements Russia reached with the London and Paris Clubs of creditors about its Soviet-era debt. In those cases, the debt was stretched out over a period of 20 years, and a grace period of 6–7 years was granted on repayments of principal.

Only in combination can these four policies work. If not undertaken together, and consistently, they will not work and indeed may be counterproductive. Clearly, the second step—reducing value subtraction—cannot be carried out without the foundation laid by the first. The third step—stopping leakage—makes sense only if done in conjunction with the second. Otherwise, it only makes the virtual economy (or its more transparent variant) more sustainable. The second step, vital as it is, will not be able to save Russia unless the country can be extracted from its debt trap—the fourth step. And yet, conversely, the West should not grant debt forgiveness unless it knows that both the destruction of

value and the leakage of value are going to stop.

The central element of any policy must be eliminating the virtual economy. Only then can real reform begin. But it must be immediately apparent that eliminating the virtual economy is a much greater task than stabilizing the currency, reducing inflation, or privatizing industry. It will involve a greater Western financial commitment to reform and greater intrusion into the affairs of Russia than either we or the Russians have hitherto considered. The critical question is whether such a program is at all politically viable. The real cost of our illusions about Russia's progress toward the market, and the inevitable crushing of those illusions in the recent crisis, is the loss of the political capital required to undertake real reforms. ■

The temptation to disengage from Russia in these circumstances is seductive. But one need only consider the long-term consequences of allowing further deterioration to realize that something must be done.

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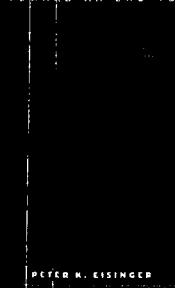
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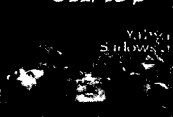
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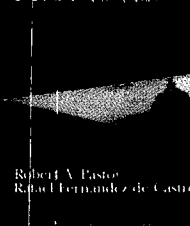
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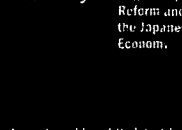
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